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CONTENTS

New Firms and the Labor Supply in Small Communities

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ALTHOUGH Nassau William Senior discussed barriers to labor mobility between localities more than a century ago,[1] the concept and term "labor market area" is relatively new to labor market analysis and wage theory. The term came into general use during World War II when the nation was faced with the necessity of interfering with those "impersonal" market forces which are supposed to allocate labor and when it was discovered, among other things, that it is extremely difficult to persuade workers to leave their home communities.

Local labor market areas may be defined as those geographic spaces within which most workers seek and find their employment and between which only a small minority of workers move from time to time. The physical size of these areas varies but they may be thought of as roughly equivalent in size to consumer trading areas, whose boundaries are a function of both transportation time and cost, and like trading areas labor market areas have fringes where two or more areas overlap.

Within each area, there are a number of "labor markets," that is, separate job markets created by differences in skill requirements and by types of institutional arrangements. Also, some "labor markets," particularly for certain skills and most professions, are much larger in spatial terms than the local areas. For a great majority of workers and thus for most employment situations, however, the local labor market area is to a large extent equivalent to the job market within which the process of matching jobs and workers takes place.

This paper comments on a significant labor market trend in the United States created by an increased amount of geographic decentralization in American industry. Factories have been moving both into the suburbs of large urban centers and into small communities entirely outside the orbit of metropolitan labor markets. We are concerned here with the location of industry in small-population labor market areas which are beyond normal commuting range of metropolitan centers. At least one-fifth of the United States population lives in these nonmetropolitan small-population labor market areas.[2]

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[1] *An Outline of the Science of Political Economy,* 1836.

[2] Nonmetropolitan means here outside the "standard metropolitan areas" as defined by the U. S. Bureau of the Census. Nonmetropolitan urban places had almost 12 million people in 1950. Add to this number a very conservative estimate of one-third of the "rural-farm" and "rural-nonfarm" population, or 18 million people, to represent people within easy commuting range of the nonmetropolitan urban centers, and we arrive at the estimate of approximately 30 million persons, or one-fifth of the 1950 U. S. population, living in the type of labor market area being discussed.

These smaller communities, along with rural areas, have been traditional suppliers of labor to the cities, since typically the supply of new workers in the small towns has exceeded the number of new job opportunities. When job opportunities do increase in such a community, the likely results in terms of labor mobility are a slowing-down of the rate of out-migration and a return of some of the previous migrants, but little or no influx of new workers from other areas.

In the following sections are reported some of the findings of several recent studies in small-population labor market areas in which the entry of new firms or the reopening of closed plants has brought about sharp increases in the number of job openings.

Although the five areas included represent a mere handful of the many hundreds of small labor market areas, they are fairly typical examples of the movement of industry into smaller communities. In addition, these few studies represent, to the knowledge of the author, virtually the sum total of recent analysis of the economic impact of employment expansion in smaller communities.[3]

The five situations are as follows: the reopening in 1951, after a 16-month shutdown, of a chemical plant, employing more than a thousand workers, in Morgantown, West Virginia, which has a population of about 25,000 (60,000 in the county); the establishment in 1953 of a petro-chemicals plant, with employment to reach five hundred or more, near Tuscola, Illinois, which has a population of about 3,000 (17,000 in the county); a general employment expansion in 1952, partly as the result of several new firms, in Kankakee, Illinois, whose population is about 26,000 (74,000 in the county); the reopening in 1952 of a shoe factory with 400 workers, after a shutdown of more than two years, in a central Illinois town of 5,000 persons (17,000 in the county); the opening in 1950 of a new shoe factory with 200 workers in a small Missouri town of 1,000 (20,000 in two counties).[4]

[3] Herbert S. Parnes notes the lack of research on labor mobility in small-population areas in his review of labor market research, *Research on Labor Mobility,* Social Science Research Council Bulletin 65, 1954. The studies reported here are Melvin E. Hartzler, Jr., *The Impact of a New Firm on a Local Labor Market* (University of Illinois, 1953, unpublished M.A. thesis in labor and industrial relations; this thesis was directed by the author and used some of the questions and classifications of the Kankakee and Shoe Town studies listed below); Gerald G. Somers, *Mobility of Chemical Workers in a Coal-Mining Area* (Bureau of Business Research, West Virginia University, 1954); and Richard C. Wilcock and Irvin Sobel, *The Secondary Labor Force in Nonmetropolitan Labor Market Areas,* to be published in monograph form by the Institute of Labor and Industrial Relations, University of Illinois, 1955. With the exception of the Somers monograph, much of this article is based on data as yet unpublished. The data for all but the Somers study were obtained through questionnaires and interviews. A discussion of methodology and research design for the Kankakee and Shoe Town studies will be included in the forthcoming monograph. This report does not cover Richard A. Lester's study of the impact of U. S. Steel's new Fairless Works because that plant is located within a metropolitan area — Trenton, New Jersey. See *Hiring Practices and Labor Competition* (Princeton University, 1954), for the first report on that study.

[4] The population data, from the 1950 Census, is rounded off to the nearest thousand.

Table 1. Civilian Labor Force Participation Rates, Five Areas Compared with Rates for United States and Several Large or Medium-Sized Cities, April, 1940 and 1950 (Persons 14 Years Old and Over)

(Percentages)

Year	Total U. S.	Urban U. S.	Rural U. S.	Los Angeles	Chicago	Atlanta	Hartford, Conn.
1950	52.9	54.7	49.4	55	57	56	59
1940	52.0	54.6	48.7	52	56	57	56

Year	Douglas County, Ill. (Tuscola)	"Shoe Town," Illinois (County)	"Shoe Town," Missouri (2 Counties)	Monongalia County, W.Va. (Morgantown)	Kankakee County, Ill.
1950	48.5	48.5	53.4	45.3	44.2

Source: Computed from U. S. Bureau of the Census, *Census of Population, 1950,* and *County Data Book, 1952.* Data for 1940 comparable with 1950 county data are not available.

In some respects, the five situations differ considerably from one another. Two involve the chemical industry with fairly high requirements for skilled and technical workers; two involve mass-production shoe plants with few highly skilled workers required. Two of the communities (Morgantown and Kankakee) are considerably larger than the other three and have some diversity of industry and a fair degree of unionization. The two shoe factories are not organized by unions and are the dominant manufacturing plants in their towns. The petro-chemicals plant has an independent union.

The ten statements which follow are tentative conclusions based upon data from one or more of the several studies (see footnote 3). For any application to similar situations, these statements should be considered only as likely hypotheses — until considerably more empirical data on small-population labor market areas are available.

1. *The labor force in a small-population labor market area is more flexible than in larger areas or for the nation as a whole and will expand with the introduction of a new firm.*

This is perhaps the most significant conclusion about the effect of new firms on small-population areas, because little of the industrial movement into small towns would occur if it were not for the availability of "surplus" labor. Although it is not suggested that the statement is universally true, it is apt to be true whenever the labor force participation rates of the population in these areas is substantially below average.[5] The Census data for April, 1950, before the expansion of employment in these towns occurred, show that their populations were less fully engaged in labor force activities than was the case for the country as a whole or for larger cities. (See Table 1.)

Several reasons may be advanced for

[5] Labor force participation rate means the proportion of any given population group which is in the labor force, that is, employed (having a job) or unemployed (actively seeking a job).

the expansibility of the labor force in small-population areas. When population growth exceeds the expansion of job opportunities, residents are reluctant to migrate elsewhere. There is a tendency to accept underemployment, meaning part-time employment for those who desire full-time employment and employment at lower earnings than could be obtained elsewhere. Many of those who do migrate to larger labor market areas are anxious to return to the home town when job opportunities develop. Young men and women who might otherwise stay in school, housewives, and retired men will enter the labor force when suitable job openings occur. Of these groups, the housewives represent the largest source of labor.

The availability of labor can be illustrated by data from the studies. Although the known number of unemployed in the Tuscola area was very small (120 in April, 1950), the new firm had hired 150 area residents, at the time of Hartzler's study, and expected to hire approximately 200 more within the area by the time the plant reached its full complement of workers.[6] In the Shoe Town where the plant reopened after a long shutdown (we shall call this Shoe Town I), one-third of those hired were persons who had once been in the labor force and now returned, while another 9 percent entered the labor force for the first time. In the new shoe factory (Shoe Town II), one-third of those hired were persons entering the labor force for the first time, while another 26 percent were returning to the labor force. Most of those who entered or re-entered the labor force in these towns were women. In Kankakee, one out of three of the "new hires" in 37 firms entered or re-entered the labor force in response to the expansion of job opportunities.

In the Shoe Towns and in Kankakee, the workers in the samples were classified as to regular (primary) labor force attachment and temporary (secondary) labor force attachment.[7] The availability of secondary labor force members in the local labor force is illustrated by the fact that this group made up 46 percent of the sample in Shoe Town I, 45 percent in Shoe Town II, and 37 percent in Kankakee.

Labor force entrance on the part of residents did not furnish all of the net labor force increase in these towns, however. Several of the plants brought about a net in-migration of workers.[8]

[6] Hartzler, *op. cit.*, pp. 6, 7, 10, 37.

[7] Persons who move in and out of the labor force voluntarily or are in the labor force temporarily or for a period less than a "normal working life" are described, while in the labor force, as "secondary labor force members" both in the Shoe Town and Kankakee studies. Those who have a regular and continuing labor force attachment are described as "primary labor force members." A discussion of the secondary labor force concept will appear in "The Secondary Labor Force and the Measurement of Unemployment" in a forthcoming volume on *The Measurement and Behavior of Unemployment,* published by the National Bureau of Economic Research.

[8] Net in-migration in small-population areas is exceptional. Donald J. Bogue in *A Methodological Study of Migration and Labor Mobility,* (Scripps Foundation, 1952) concludes ". . . it should not be expected that an increase in job opportunities in a nonmetropolitan area would cause an immediate net influx of workers from other areas, as appears to be the case in metropolitan areas . . ." (p. 25)

Table 2. Female Labor Force Participation Rates, Five Areas Compared with Rates for United States and Several Large or Medium-Sized Cities, April, 1940 and 1950 (Persons 14 Years Old and Over)

(Percentages)

Year	Total U. S.	Urban U. S.	Rural U. S.	Los Angeles	Chicago	Atlanta	Hartford, Conn.
1950	28.6	32.6	20.4	33	34	35	39
1940	25.4	31.2	16.4	28	31	37	34

Year	Douglas County, Ill. (Tuscola)	"Shoe Town," Illinois (County)	"Shoe Town," Missouri (2 Counties)	Monongalia County, W.Va. (Morgantown)	Kankakee County, Ill.
1950	20.4	19.1	23.2	22.8	24.3

Source: Computed from U. S. Bureau of the Census, *Census of Population, 1950,* and *County Data Book, 1952*. Data for 1940 comparable with 1950 county data are not available.

In Tuscola more than 40 percent of the first group of workers were recruited outside the area and it was expected that one-third of the final employment total would be in-migrants. In this situation, the company found it necessary to take active measures to bring in the requisite number of experienced chemical workers, yet a number of the in-migrants were "returnees" to the area.[9] In Morgantown,

> With local employment opportunities declining or unstable, an exceptionally large number of workers left the . . . area . . . The strong pull of locational factors was evident, however, in the return of many of these workers to their home area by 1950 and their movement to the chemical plant in 1951.[10]

In Kankakee, one-third of the "new hires" in manufacturing, trade, and services had been residents of the area less than three years and about one-third of the postwar in-migrants had previously lived in the area.

The chemical plants and Kankakee attracted in-migrants both through the opening up of jobs and favorable wage rates. The shoe plants did not have the attractive wage scales to attract new residents to their areas and relied primarily on labor already in the areas. To the extent that these plants did attract in-migrants, however, they were former residents who took advantage of the opportunity to return "home." In Shoe Town I, for example, one out of five of the shoe factory employees had moved elsewhere during the period when the plant was closed and returned when it reopened but the other four had lived in the area for five years or more.

2. *The female labor force can expand without in-migration.*

This statement is corollary to the preceding one and recognizes that one of the reasons why there is potential labor force expansion in many small-population areas is the typical scarcity of employment opportunities for women. The potential in the five towns is shown for April, 1950. (See Table 2.)

[9] Hartzler, *op. cit.*, p. 10 ff.
[10] Somers, *op. cit.*, p. 29.

The two chemical plants hired women only for their office forces, and to obtain male production work forces of the necessary size and skills had to rely upon in-migration as well as upon local applicants. In Kankakee, employers obtained the necessary number of workers both through in-migration and through an increase in the proportion of the area population in the labor force. Although most of the employment expansion occurred in manufacturing, most of the jobs for new labor force entrants were in nonmanufacturing. Two out of three of the new hires in nonmanufacturing were women, many of whom had just entered or re-entered the labor force.

In each of the Shoe Towns, the factory work forces had three women to each man. Also, in each of the towns three out of five women were classified as secondary members of the labor force. In Shoe Town I, many of these women temporarily in the labor force had worked for the company before the plant was closed, sought no other employment during the shutdown of more than two years, and returned to the company when the plant was reopened. In Shoe Town II, many of the women employees took their first jobs when the shoe plant opened.

The significance of these briefly sketched data is that labor force participation rates, while relatively stable for the United States as a whole, and slow-changing in diversified-industry metropolitan areas, can change drastically and rapidly in small-population areas, often with the entry or departure of one factory. Unfortunately, data are not available to show the rates in the study areas after the rapid employment expansion had taken place, but the evidence from the sample data indicates that the changes were fairly large.[11]

3. *The male labor force requires in-migration for expansion, but unless specially recruited, the in-migrants are apt to be "returning natives."*

Of the five areas under consideration, only Kankakee drew a considerable number of in-migrants who had not previously lived in the area and were not actively recruited by employers. The petro-chemicals plant advertised in the newspapers of appropriate areas for workers experienced in the chemical and petroleum-refining industries and in trade journals for some kinds of engineers and instrument makers. In Morgantown, the chemicals plant had previously been in operation and was able to attract many of its former workers, even though a sizable proportion had obtained jobs outside the local market area.

A tentative conclusion seems to be that the typical small-population area with a new or reopened plant can expect some of the area's ex-residents to return but cannot expect new migrants to respond to the opening of the plant without active recruitment. Kankakee, during the Korean War, was an exception apparently for several reasons: It

[11] It might be noted parenthetically how inadequate measures of unemployment are in indicating the availability of labor in local labor market areas. The large place-to-place variations in the proportion of women in the labor force is discussed by Nedra Belloc in "Labor-Force Participation and Employment Opportunities for Women," *Journal of the American Statistical Association,* September, 1950, pp. 400-10.

Table 3. Primary Reasons Given for In-Migration

(Percentages)

Reason	Kankakee[a]	Kankakee[b]	Tuscola	Shoe Town I
Look for or accept work	36	38	79	33
Relatives or friends in area	13	33	8	15
Came with family	25	17	4	52
To go to school	20	7	4	..
Other	6	5	5	..
Total	100	100	100	100
Percent of total sample	33	14	62	29

[a] Those who had never lived in area before.
[b] Those who returned to area.
Sources: Questionnaires and interviews.

is a larger area than the others, with greater industrial diversification; it lies in what might be called a "migratory corridor" leading to Chicago; and in-migration was cumulative with earlier in-migrants informing friends and relatives of the new plants and jobs. Some of the reasons given by the workers for migrating to the several towns are given in Table 3. In general, it can be said that most of the in-migrants moved either for "better opportunity" or to live where they wanted to or for both reasons.

As would be expected, a large proportion of the petro-chemicals in-migrants went to the area to accept jobs. The "returnees" to the Shoe Town where the factory reopened and to the Kankakee area did so for the most part because of family or friends. Without the job opportunities, however, the number of returning "natives" would undoubtedly have been much smaller.

4. *New firms rarely draw upon farm labor.*

This may be true in these studies because of the fairly prosperous level of farming in recent years and because none of the studies took place in an area where agricultural output was declining, but it is of interest that in the five towns few of the manufacturing workers came directly from the farms. In Tuscola, none of the in-migrants reported agriculture as their previous industry and only 5 percent of the local workers did so, even though agriculture was the major industry in the area in terms of employment (33 percent).[12] In the other four towns, between 5 and 10 percent of the factory workers reported that their previous jobs were in agriculture.

These data probably underestimate the movement from farm to factory employment, but apparently much of the movement that does occur is "by way of" nonmanufacturing jobs. This is suggested by the fact that in Shoe Town I, 35 percent of the study's respondents had rural residences; in Shoe Town II, 59 percent; in Kankakee, 29

[12] Hartzler, *op. cit.*, pp. 15, 24.

Table 4. Nonfarm Occupational Groups: Douglas County, Illinois, 1950, and Petro-Chemicals Plant, 1953

(Percentages)

Occupational Group	County	Company	
		In-migrants	Local workers
Professional, managers, etc.	25	41	3
Clerical, sales, and kindred	30	2	26
Foremen and craftsmen (skilled)	18	34	21
Operatives (semiskilled)	18	11	37
Laborers (unskilled)	9	8	9
No data	..	4	4
Total	100	100	100

Sources: *U. S. Census of Population, 1950,* and questionnaire data.

percent; in Tuscola, 15 percent.[13] The previous employment of most of these rural dwellers, however, was in trade, services, transportation, or construction.

5. *Small-population areas typically have very limited supplies of skilled and technical labor.*

6. *A new firm in a small-population area tends to up-grade the area's skill level.*

These statements are closely related because a new manufacturing plant in a small town or city usually has to train workers for the more skilled jobs or bring them in from outside. In either case, the average skill level of the local population increases, tending to reverse the trend of ambitious young men migrating to larger labor market areas to find suitable job opportunities.

In Kankakee, the new plants contributed to the up-grading process largely through on-the-job training and recruitment outside the area of engineers, laboratory technicians, and some highly skilled craftsmen. In Tuscola, the petro-chemicals plant obtained semiskilled workers locally and trained them but recruited skilled and technical workers from outside the area. In Morgantown, the reopened chemical plant drew upon many workers who had had previous experience in the plant, a number of them returning from jobs outside the area. Both shoe factories hired a number of persons with previous experience in shoe manufacturing in their localities. Those without experience were trained on the job. Shoe industry skills are described as "largely a matter of experience," with an inexperienced worker taking about a year to reach average efficiency.[14]

The impact on skill levels of a new firm can be illustrated at least roughly by Table 4, which shows the broad oc-

[13] Data not available in Somers study. In areas where farming tends to be marginal, a larger proportion of rural dwellers will have or seek nonfarm employment in the locality. See Morris A. Horowitz, *Farm and Non-Farm Work by Open Country Residents in Two Southern Illinois Counties,* (University of Illinois, Institute of Labor and Industrial Relations, 1948).

[14] Interviews with plant managements.

Table 5. Average Length of Time on a Job,[a] Five Towns and Six Cities

City or town	Length of job in years	City or town	Length of job in years
Six cities (all men)[b]	3.3	Shoe Town I (total sample)[c]	1.5[e]
Six cities (in-migrants)[b]	2.8	Shoe Town II (total sample)[c]	2.5[e]
Tuscola (local workers)[c]	1.7	Morgantown (chemical operators)[f]	2.6
Tuscola (in-migrants)[c]	2.4	Morgantown (skilled maintenance)[f]	2.3
Kankakee (total sample)[d]	0.9[e]		

[a] Job as used here means length of time, without a long break, with the same employer.
[b] Based on work histories, 1940-49. The six cities are Chicago, Philadelphia, New Haven, St. Paul, San Francisco, and Los Angeles.
[c] Work histories, September, 1945-June, 1953.
[d] Work histories, September, 1945-July, 1952.
[e] Adjusted for average length of time in the labor force because of the large proportion of secondary labor force members.
[f] Employment records, for period from 1940 through 1951.
Sources: Computed from data in Gladys Palmer, *Labor Mobility in Six Cities*, (Social Science Research Council, 1954), Ch. 3; Somers, *Mobility of Chemical Workers*, pp. 36, 39; Hartzler, *Impact of a New Firm*, p. 13; interviews and questionnaires (Shoe Towns and Kankakee).

cupational groupings in Douglas County, Illinois, before the new plant came in, in comparison with the occupational groupings in the new plant.

The table indicates that the immediate impact on skill levels was exerted through in-migration. Although for the local workers comparison of their new jobs with their old ones showed a net down-grading of skills, the company was training most of them for more highly skilled jobs.

7. *Labor mobility rates tend to be higher than in large-population labor market areas.*

Table 5 suggests that small-population area workers change employers more often than do workers in large metropolitan areas.

Although each of the small-community situations differs in detail, the main explanation for the higher degree of job changing in the smaller areas seems to lie in the failure of many smaller communities to have an adequate amount of continuing job opportunities for those who wish to live in them. The potentially volatile nature of employment in such communities is graphically illustrated by the current United States Bureau of Employment Security list of 98 Smaller Group IV-A (substantial labor surplus) and IV-B (very substantial labor surplus) Areas. Morgantown, for example, is on this list with a 10.5 percent decline in nonfarm employment and a 78 percent increase in unemployment in one year.[15]

8. *New firms exert a "pull" and attract workers for economic reasons.*

Differing substantially from the workers in larger labor market areas, who were reported as knowing relatively little about alternative opportuni-

[15] *The Labor Market and Employment Security*, September, 1954, pp. 66-68.

ties,[16] the workers in the small-population areas seem to have a very good knowledge of the types of job openings. Although many job changes were brought about by layoffs, a majority were voluntary moves in search of and in response to better wages, working conditions, and economic security.

In Morgantown, "the move to the chemical plant was induced by the combined pull of economic advantage and locational preference."[17] In Kankakee, two out of three of the new hires knew something about the company where they sought and obtained work, with a majority of these having some detailed information. Furthermore, more than 80 percent of the respondents were able to name the company where they would most like to work (almost a third of these naming a company other than where they were working) and to give specific reasons for their preference.

Finally, more than half of those who had quit their previous jobs did so only when they knew of other job openings and had an expectation of improving their economic position. As for the Shoe Towns, most of the shoe workers who had quit their previous jobs gave wages, "better opportunity," or return to the labor market area as their reasons.

9. *Major changes in the composition and size of a local labor force can occur without drastic changes in the local wage structure.*

In the five areas studied, and probably in most such areas, a new plant comes in or an old one reopens only when the management is confident that labor is available. As pointed out earlier, the labor force in the typical small-population area is expansible, and it is significant that it is expansible, within limits, without a major distortion of the prevailing wage rates in the area.

In the two chemical plants and in the new firms in Kankakee, most of the new workers did experience higher earnings compared with their previous employments, but the increases were not large. In fact, quite a few of the non-migrant workers started at lower wages than on their preceding jobs but were attracted by the "total expectancies" of employment stability, chances for training and up-grading, and wage advances which could only be achieved over a period of years.[18]

The shoe plant wage rates were comparable with those of other shoe factories in small towns, and it can be fairly said that many shoe factories are located in these small towns because the available labor will accept the relatively low wage rates established by the fierce competition in the industry. Interestingly enough, a third of the respondents in the shoe plants considered their earnings better than they had expected. In none of the five situations, then, was the management forced to offer wage rates out of line for comparable jobs in order to recruit work forces although, in each case, the num-

[16] See George Shultz, "Recent Research on Labor Mobility," *Proceedings, Industrial Relations Research Association,* 1951, pp. 110-18.

[17] Somers, *op. cit.,* p. 32.

[18] See discussion of "total expectancies" by J. Douglas Brown in Lester, *op. cit.,* p. 3.

ber of workers required represented a major increase in the employment of the area.

10. *Labor markets for manufacturing workers are less "structured" than in large-population areas.*

The typical industrial worker in the United States today, after perhaps an initial period of shopping around among employers, looks for his economic advantage through promotion, seniority, and length-of-service with the same employer. In many small-population areas, however, such attachments have been less strong simply because the employment pattern has been unstable. In addition to the sharp employment fluctuations, however, the higher mobility rates in the smaller communities may be related to a less rigid labor market structure in which manual workers, at least, can more easily shift among the available industrial and occupational opportunities. In Kankakee, for example, it was quite common for manual workers to shift among the several plants as employment levels at each plant changed. In spite of the limited range of industries and occupations, workers in the five towns had not only changed employers more often than workers in the six large cities but had also made more shifts between industries and between occupations.

To the extent that labor market activity is more intense in these small areas and that workers seem to have a greater knowledge of alternative opportunities and respond to them more readily, the labor markets might be said to approach the neoclassical model of the labor market. This may be true to a degree, but it does not mean that the mobility of the workers is sufficient "for the wages of labourers of equal efficiency to become equalized in different occupations."[19] Although the expanding employment did pull in workers from other areas, from other employers, and from outside the labor force, and much of the incentive was economic, the studies indicate that the mere existence of the job openings was as important as the particular wage rates offered. In other words, the labor supply was available and would have been available within a fairly wide range of wage offers. This is not to say, however, that the level of the wages within this range would not have some effect on the "quality" of applicants and on the productivity and morale of the work force.

As new firms become established in small communities, and particularly if collective bargaining is introduced, the labor markets become more structured and potential mobility is reduced. Seniority, employee benefits, and other factors will add employer attachment to community attachment. Increasing industrialization tends to make small-community labor markets somewhat simpler versions of large industrialized areas. Very often, in the space of a few years, a smaller community will shift from a situation where all the employers are local entrepreneurs to one in which the major employers are managers of branch plants owned by large multi-plant firms.

Under such circumstances, labor mo-

[19] J. R. Hicks, *The Theory of Wages*, (New York: Macmillan, 1935), p. 3.

bility can be expected to decrease, particularly if the new plants bring more stable levels of employment to these communities. Out-migration, and movement of workers between employers, industries, employment and unemployment, and in and out of the labor force would all be reduced. Only occupational mobility could be expected to increase, primarily as a result of upgrading within the plants.[20]

Summary

Although many factors are involved in the location of an industrial plant, a major reason for the introduction of factories in small-population areas in recent years has been the availability of labor and the expansibility of the local labor forces. Attachment of workers to their home communities, the desire of migrants to return when economically feasible, and the willingness of women to enter the labor force are important labor supply factors. Instead of being suppliers of labor to the metropolitan areas, these small-population areas, which have a fifth or more of the United States population, are finding an increasing amount of industry coming to them.

Women are the largest source of labor in the smaller communities, but firms employing mostly men are able to recruit work forces, even though few workers come directly from the farms and skilled workers either have to be trained or "imported."[21] In-migrants who are native to the area return in response to the new jobs in the "home town" but skilled and technical workers who are not natives of the area respond to recruiting efforts that emphasize the economic advantages of working and living in a small community.

The new firms exert a positive "pull" and attract workers for economic reasons, particularly through the "total expectancies" of potential earnings, promotion possibilities, and economic security. The new firms are able to establish wage rates which do not create any major distortions in the local wage structure but their average rates are apt to be above the community average, partly because the general level of skills required is likely to be above that existing in the community.

Finally, as new firms become established they are likely to bring about a reduction in the generally high labor mobility rates of smaller areas and to add to the increasing "institutionaliza-

[20] See Clark Kerr, "Labor Markets: Their Character and Consequences," *Papers and Proceedings, American Economic Review,* May, 1950, pp. 278-91, and "Balkanization of Labor Markets," in *Labor Mobility and Economic Opportunity* (Cambridge: Technology Press of the Massachusetts Institute of Technology, 1954), pp. 92-110, for a theoretical discussion related to some of the comments in this section.

[21] Although the labor market area involved is a larger one than those discussed here, U. S. Steel was able to go into an area of less than 100,000 population with its Fairless Works, expecting to recruit five thousand of a required six thousand workers (all but the most skilled workers) in the local area during a period of high-level employment. See Nathan Belfer, "Some Economic Effects of the New Morrisville, Pennsylvania, Steel Plant," *Current Economic Comment,* August, 1953, pp. 44-56, and Lester, *op. cit.*, pp. 69-72.

tion" of the markets for labor in these areas.[22]

[22] A thorough report on the impact of a plant shutdown on a small-population labor market area, the opposite situation to those described in this article, is contained in Charles A. Myers and George P. Shultz, *The Dynamics of a Labor Market* (New York: Prentice-Hall, 1951). The fact that Myers and Shultz found that economic "motives" became predominant when employment declined drastically, when added to the evidence of the economic "pull" of new firms, suggests that, in spite of barriers, economic forces do operate in labor markets in the direction of net economic advantage, however imperfectly. See pages 197-204.

The Case for Discretion in Monetary Policy

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IN RECENT YEARS there has been a considerable revival of interest in the use of monetary policy as an instrument for obtaining economic stability.[1] Participating in this revival of interest are both academic theorists who have presented their arguments for active use of monetary techniques[2] and governmental officials who have used monetary instruments in attempts to control the price level.[3] In large part, the renewed interest in monetary policy appears to be related to the prolonged rise in prices during the postwar period. It also reflects the difficulties which were encountered in attempting to combat postwar inflation with fiscal policy while monetary policy was subordinated to the needs of the Federal Treasury. When Federal surpluses in the fiscal years ending in 1947, 1948, and 1951 failed to halt price increases, many persons sought other methods which might be used to stabilize the price level.

Active use of monetary policy began during the last years of the Truman administration. The Treasury-Federal Reserve "Accord" of 1951 allowed the Board of Governors to pursue a monetary policy which was not limited to the support of the Federal securities market. This use of monetary instruments also appears to be supported by the Republican administration.[4] Indeed, if the number of individuals formerly associated with the Federal Reserve System in one capacity or another who have assumed important positions in the Eisenhower administration

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[1] For an optimistic appraisal of what monetary policy can accomplish toward stabilizing the economy see the address by W. Randolph Burgess, Deputy Under Secretary of the Treasury before the joint meeting of the American Economic Association and the American Finance Association in Washington, D. C., on December 29, 1953.

[2] See Lloyd W. Mints, *Monetary Policy for a Free Society* (New York: McGraw-Hill Book Company, 1950). There also have been a number of articles dealing with the use of monetary policy. See the section concerned with monetary theory and central banking in *Money, Trade, and Economic Growth; Essays in Honor of John Henry Williams* (New York: Macmillan, 1951). Also Robert V. Rosa, "The Revival of Monetary Policy," *Review of Economics and Statistics*, February, 1951; L. V. Chandler, "Federal Reserve Policy and the Public Debt," *American Economic Review*, March, 1949; articles by Milton Friedman and L. V. Chandler in "The Controversy over Monetary Policy," *Review of Economics and Statistics*, August, 1951.

[3] Evidence of this is found in the increases in the rediscount rates of the Federal Reserve Banks in August, 1950, and January, 1953, and the removal of the "pegs" or supports of the United States bond market following the Treasury-Federal Reserve "Accord" of 1951.

[4] See the *State of the Union Message* delivered to the Congress by President Dwight D. Eisenhower on February 2, 1953, for evidence that his administration proposes to deal with the problem of inflation through the use of credit controls. For an appraisal of the importance of central banking under the Eisenhower administration, see the article by Paul Heffernan in the New York *Times*, January 18, 1953, p. 1F.

is any guide,[5] the Republican administration has a healthy respect for the Federal Reserve.

A cursory examination of Federal Reserve activities during 1953 and the first half of 1954 clearly reveals that monetary powers were used to moderate cyclical fluctuations. During early 1953 Federal Reserve operations restrained credit extension and monetary expansion in order to combat inflationary forces. After mid-1953, these operations were designed to restrain deflationary forces in the economy. The activities of the Board of Governors during the first half of 1954 also were designed to avoid deflation and contraction in the economy by lowering interest rates and promoting a condition of easy credit.[6]

I.

Because of the importance of monetary policy, it is desirable to re-examine both the possible goals toward which such policy may be directed and the general problem of the conduct of monetary policy. Most economists, including the writer of this paper, are agreed that some type of economic stability is a desirable goal for monetary policy. In a free enterprise society, however, it is impossible to stabilize all elements of the economy. Such stabilization would be tantamount to freezing the economy and would make economic progress impossible. For this reason most advocates of stability as a monetary goal propose to stabilize one or more important parts of the economy. The two parts most often singled out for stabilization are the general level of prices — or the purchasing power of money — and the volume of employment. It is not the purpose of this paper to discuss which part or parts of the economy, if any, should be singled out for stabilization by monetary authorities. Rather it is proposed to discuss the discretion which monetary authorities may exercise in their attempts to attain these broad objectives.

A small but very vocal group of American economists have been advocating the use of a single rule or a limited number of fixed monetary rules for almost twenty years. They believe that monetary authorities should be compelled to take action according to rules which are based upon objective economic factors. For convenience, this may be called the "rules" approach to monetary policy.

The most able, if not the earliest, proponent of a fixed set of rules for monetary policy was the late Henry

[5] Among the officials of the Eisenhower administration who were formerly associated in various capacities with the Federal Reserve System are: Marion Folsom, Under Secretary of the Treasury; W. Randolph Burgess, Special Deputy to the Secretary of the Treasury, charged with responsibility for the management of the public debt; Robert B. Anderson, Secretary of the Navy; and Robert T. Stevens, Secretary of the Army.

[6] For a summary of Federal Reserve operations during 1953 and the first half of 1954 see the *Federal Reserve Bulletin*, July, 1954, pp. 681-88. In this issue the Federal Reserve authorities state that "As economic activity began to recede, System operations were further modified toward promoting credit ease." (p. 682)

Simons[7] of the University of Chicago. Professor Simons and his colleague, Professor Lloyd Mints,[8] have urged the adoption of a stable price level as the rule for monetary action. Adoption of such a rule would compel the monetary authorities to take definite action to counteract changes in the general price level. Their action would be calculated to guarantee absolute stability in the purchasing power of money.

Professor Simons strongly urged the adoption of a simple definite rule for monetary policy and he was of the opinion that the authorities should be allowed no discretion but should be compelled to use monetary powers in strict conformity with the rule.[9] He felt that such a rule was desirable per se, for its adoption would eliminate uncertainty concerning the future value of the monetary unit. This elimination of uncertainty was a central part of Professor Simons' "Positive Program for Laissez Faire." His preference for such a simple definite rule was so strong that he suggested the possible adoption of one which would fix the total amount of the money supply.

A number of the colleagues and students of Henry Simons have enlarged, elaborated upon, and modified his program. One of these, Professor Clarence Philbrook of the University of North Carolina, contends that in the absence of a clearly defined and stated rule or rules for monetary action, no actual policy can be said to exist. According to his reasoning, the recent policy statements of the Board of Governors[10] are so vague and poorly defined as to lack the essential characteristics of policy.

II.

Opposed to the fixed rule approach is the policy of flexibility or discretion. Proponents of a flexible monetary policy advocate the use of judgment in the exercise of monetary power. They contend that the Board of Governors should use its open market, rediscount rate, legal reserve requirements, and other powers whenever action is needed

[7] Professor Simons' views concerning monetary policy are presented in his article "Rules Versus Authorities in Monetary Policy," *The Journal of Political Economy*, February, 1936. His proposals are placed in their setting as part of his program for economic reform in the pamphlet, *A Positive Program for Laissez Faire* (Chicago: University of Chicago Press, 1934). The proposals for banking reform advocated by Professor Simons and his colleagues at the University of Chicago are described in an article by A. G. Hart, "The 'Chicago Plan' of Banking Reform," *Review of Economic Studies*, Vol. II (1935). Although Professor Simons died in 1946, his associates and former students continue to advocate his principal proposals. Among the most active of this group are Professors Milton Friedman and Lloyd Mints of the University of Chicago, Professor Clarence Philbrook of the University of North Carolina, and Professor James Buchanan of Florida State University. Mr. Clark Warburton also appears to support this use of rules in monetary policy. See his paper "Rules and Implements in Monetary Policy," *Journal of Finance*, April, 1953.

[8] See L. W. Mints, *Monetary Policy for a Competitive Society* (New York: McGraw-Hill, 1950), pp. 134 and 136.

[9] See "Rules Versus Authorities in Monetary Policy," *loc. cit.*

[10] For a statement of current Federal Reserve policy goals couched in precisely the general terms criticized, see "Statement by Chairman of the Board of Governors before Subcommittee on General Credit Control and Debt Management," *Federal Reserve Bulletin*, April, 1952. In this statement, Chairman Martin stresses the need for "flexible credit and monetary policy."

to maintain economic stability. In the exercise of such powers the Board would consider economic factors such as the level of employment, the value of money, and the balance of trade. Such objective economic conditions would serve as "guides" rather than "rules" in policy making. This distinction between guides and rules is far more important than a mere play upon words. Rules would compel a given course of action whereas guides may or may not bring about such action. In short, the use of economic indicators as guides to monetary action would permit monetary authorities to exercise some discretion in the formulation and application of monetary policy.

The adoption of a flexible or discretionary policy is not inconsistent with a desire for a high degree of economic stability. Policy makers would seek to stabilize the price level and the volume of employment at a high level, but their policies would not always conform to a specific objective rule or set of rules.

III.

Should the Board of Governors adopt a clearly defined and openly stated rule or group of rules for monetary action which they would be compelled to follow henceforth? Should they take such action in order to remove uncertainty as to the future course of monetary policy? Should they relinquish their ability to exercise discretionary powers? It is the opinion of the writer that these questions should be answered in the negative.

In a real way, the adoption of a fixed rule or set of rules for monetary policy appears to be a modern version of the fixed courses of action available to monetary authorities under the "rules of the game" of the traditional gold standard. The traditional gold standard rules called for tighter credit in response to an outflow of gold and easier credit in response to a gold inflow. Thus the gold outflow would be halted by lower prices and higher interest rates while the gold inflow would be checked by higher prices and lower interest rates. This conception of monetary powers in terms of the flow of gold meant that such powers were to be used primarily to protect the supply of bullion.

It appears that the most persuasive arguments for the "rules" approach to policy making are similar to those advocated in support of strict adherence to the rules of the traditional gold standard. One of the most persuasive of these arguments is that the adoption of fixed rules would remove monetary policy from the political arena. While Bryan's famous rallying cry of free coinage at the ratio of 16 to 1 is perhaps a little dim to modern ears, it appears that it would be difficult, if not impossible, to remove monetary matters from political controversy. The abandonment of the gold standard throughout the world undoubtedly made possible greater use of monetary tools to achieve political ends. But the traditional gold standard tended to benefit the creditor group, which was very important politically, and it is difficult to maintain that a monetary policy designed to aid other important groups should not be adopted.

Another argument which may be used to support both the gold standard and the rules approach is the removal of uncertainties concerning the future value of the money unit. Certainly the historical record does not support the view that the gold standard provided a monetary unit with a constant purchasing power. While it may be argued that there would have been even greater changes in the value of the money unit in the absence of the gold standard, the fact remains that the United States experienced large price level changes during its gold standard period. The "rules" approach could not produce stability in the purchasing power of money unless this were the only rule or at least the most important rule which bound the authorities. Assuming that the rule of a stable price level were adopted by the monetary authorities and that they were compelled to take all possible action to maintain the stability of the value of the money unit, it is necessary to ask: Do the monetary authorities today have sufficient power to guarantee a stable price level?

In the face of a threatened price rise the Board of Governors could raise the rediscount rate, increase legal reserve requirements for the member banks, sell United States securities in the open market, and utilize certain other minor powers. At present there is no statutory limit upon changes in the rediscount rate. In practice, however, the effectiveness of the rate increases is determined by the willingness of the member banks to borrow from the Reserve Banks. The maximum limit to the legal reserve requirements of the member banks is determined by statute. In times past the Federal Reserve authorities have requested increases in these maximum ratios. Although temporary increases have been permitted, the maximum ratios today are identical with those which were provided by the Banking Act of 1935. The degree to which open market powers may be utilized is limited by the ownership of Federal securities by the Reserve Banks. Because the Federal security portfolios of the Reserve Banks now exceed $25 billion it appears that this is the most important single anti-inflationary instrument available to the monetary authorities. The principal limitation upon the use of this instrument is the danger of demoralizing the bond market in the process of reducing member bank reserves. Such demoralization might bring financial panic which could have more serious economic consequences than continued inflation. But within the limits imposed by statute and the need for exercise of caution, it may be argued that the Federal Reserve has considerable powers to control price inflation. Successful exercise of these powers will be based upon the absence of any offsetting action by the fiscal authorities.

But what about deflation? Obviously the same powers may be used in a different manner to control deflation. The rediscount rate might be reduced but it cannot go below zero. If there were no demands for loans by the customers of the member banks these banks might be reluctant to borrow at any positive rate of interest. Reductions in reserve requirements are limited by statute, and the ability of the Reserve

Banks to purchase additional bonds in the open market is limited by the Reserve Banks' reserve ratios. While such statutory restrictions might be removed, it appears that the principal difficulties which the monetary authorities would encounter in the event of a price decline are not statutory in origin. The real difficulties lie in an inability of the authorities directly to control the velocity or turnover of the money supply and consequently their inability to control the rate of spending. The tools available to them are operative upon the money supply. Undoubtedly, the money supply can be increased greatly to offset declines in velocity of money turnover. Nevertheless, in the face of a large-scale deflationary movement it appears doubtful that money supply increases would offset reductions in velocity sufficiently to maintain the price level. If existing powers of the monetary authorities are inadequate to guarantee price stability, at least on the downside, it would appear to be undesirable to charge them with a responsibility for maintaining a fixed price level. For it is manifestly unfair to charge them with responsibilities which exceed their capacities.

In fairness to Professor Simons and the other members of his "school" it should be pointed out that they are acutely aware of these limitations upon the powers of the monetary authorities. For this reason their policy proposals have frequently been accompanied by a proposal to eliminate fractional reserve banking.[11] This could be accomplished by the adoption of a 100 percent legal reserve requirement for all commercial banks. By this reform, the powers of the monetary authorities would be greatly strengthened. Under a system of 100 percent reserves an increase in central bank credit would bring about a corresponding increase in purchasing power available to the public. Thus the Reserve Banks would be able to control directly the volume of demand deposits, in contrast to their present powers which are primarily directed at control of member bank reserves. But even this reform would not allow the monetary authorities to control the volume of spending. The public would retain the decision to spend or not to spend the newly created purchasing power. And without some sort of direct control over the volume of spending it would be difficult to combat general deflationary movements. It is possible to devise a technique which would allow the monetary authorities to control the rate of spending, and a number of ingenious devices have been constructed for this purpose.[12] But these have not received serious consideration from either economists or public officials.

Since it appears that a rule compelling monetary authorities to maintain a stable price level is difficult, if not impossible, to attain under present conditions, it is desirable to analyze the practicality of other proposed rules.

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[11] See A. G. Hart, "The 'Chicago Plan' of Banking Reform," *loc. cit.* For a dissent to the idea that banking reforms are needed in order to have effective monetary policy, see Clark Warburton, "Monetary Difficulties and the Structure of the Monetary System," *Journal of Finance*, December, 1952.

[12] For an appraisal of some of these plans see A. G. Hart, *Money, Debt, and Economic Activity*, 2nd ed. (New York: Prentice-Hall, 1953), pp. 431-48.

One policy rule or goal which is often suggested is that of full employment. Could such a rule be adopted and could the monetary authorities guarantee the maintenance of full employment conditions? Again compliance with such a rule seems impossible. The same difficulties which seem to be inherent in the effort to comply with a fixed price level rule would also be present in connection with the full employment rule. In the face of declining employment, monetary authorities would find it difficult to bring about increased spending in order to bolster up demand with consequent effects upon employment. Their difficulties in controlling spending arise from their inability to control the velocity of money. And without control over spending they could not guarantee full employment. Thus the full employment rule is just as impractical as the fixed price level rule.

Undoubtedly, there are rules which the monetary authorities could adopt and successfully implement. One rule of this type is the stable money supply rule. If the monetary authorities fixed the money supply in terms of an exact amount of money they could probably maintain this amount of money over a period of time with existing powers. But what would be the effects of the adoption of such a rule?

Maintenance of a fixed money supply in the face of changes in the volume of production and employment might bring about serious economic consequences. If the volume of goods and services offered in the market place increased significantly, the existing money supply would have to be more fully utilized by an increase in its rate of turnover, or prices would fall. Prospects of future increases in the volume of goods and services offered appear reasonably good in view of the increases in production and population in recent years. While psychological factors play a significant part in the determination of the velocity of money, habits and institutional factors are also important. Certainly, it would appear to be risky to place the entire burden of adjustment to the changing volume of transactions upon the velocity of money. Inelasticity of the money supply under the National Banking System was one of the primary reasons for the establishment of the Federal Reserve System. If velocity changes did not fully offset changes in the volume of transactions, then the price level would be forced to adjust to changes in the volume of production and employment. It appears that a flexible money supply, wisely managed, would result in a much more stable price level than would a completely inflexible money supply.

From this brief appraisal of three possible rules for monetary action it appears that the rules which have been widely advocated are difficult, if not impossible, of achievement. And one of the rules which could be successfully complied with would not materially contribute to economic stability. But there is an additional objection to the entire rules approach. If Federal fiscal policy is to be utilized as a force making for economic stability, it is important that monetary and fiscal activities be coordinated. The adoption of a fixed rule for monetary action would make such coordination impossible, for the monetary authorities could not always

adapt their policies to those of the fiscal authorities. Because of the lag between budgetary proposals and the enactment of revenue and appropriation measures it would appear highly desirable for monetary policy to be flexible enough to take account of changes or impending changes in fiscal policies.[13]

In many ways monetary instruments tend to compliment fiscal techniques. While monetary powers may be deficient as instruments in combating depression and deflation, fiscal instruments are difficult to employ effectively in combating inflation and overexpansion. As a practical political matter, it has been difficult to obtain Federal budgetary surpluses of sufficient size to reduce spending and incomes significantly during inflationary periods. Yet by means of Federal spending and tax policies it is possible to place purchasing power in the hands of income groups who are likely to spend the money quickly, thus increasing demand in times of deflation and depression. Monetary and fiscal instruments also are complementary in other ways. Fiscal policy usually must not only be announced openly in a democracy but also it is slow to implement. On the other hand, monetary powers can be employed quickly and without fanfare.

The part of fiscal policy relating to the management of the public debt must be closely correlated with monetary conditions, and such debt management may legitimately be subordinated to monetary considerations. But overall, it may be desirable to use monetary powers as the primary weapons to combat inflation and overexpansion, and fiscal powers as the primary weapons to combat deflation and depression. Since changes in the business cycle may be expected, it may be necessary to shift from the use of fiscal to monetary powers. Certainly proper coordination of the two types of instruments may be expected to achieve a higher degree of control over vital economic conditions, such as the general price level and the volume of employment, than could be expected without coordination.

IV.

Advocacy of discretion in the formulation and execution of monetary policy should not be mistaken for advocacy of irresponsible monetary management. Monetary authorities should base their policy solidly upon broad economic goals such as a high level of employment and a relatively stable price level. They should also consider the effects of their policies upon international relationships and the conditions which are necessary for economic progress. In short, their policy must be based upon a concern for a broad view of the national economy rather than a restricted view of any one segment to the exclusion of other important parts. Their actions should constitute the best course available for the entire economy, and they should recognize that their policies will inevitably benefit certain groups and harm other groups. But if

[13] For a clear statement of the need for coordinating fiscal and monetary policies see the paper by L. V. Chandler, "Taxation as an Instrument for Inflation Control," which was published in *Limits of Taxable Capacity* (Princeton: Tax Institute, 1953).

they consider the national interest they will make their decisions in terms of the long-run benefits for the largest groups; and over the long run many of the short-term conflicts will be erased.

Certainly policy making in terms of such broad objectives requires a high degree of skilled judgment. Adoption of a fixed rule for action would mean that such judgment would no longer be needed. But there is as great a need for careful application of considered judgment in the monetary field as in other important parts of the economy. Doubtless, a higher degree of skill and judgment should be exercised in the future than has been the case in the past. But merely because monetary authorities may have been mistaken in the past does not mean that they should be stripped of all discretion. Surely the men who control the monetary tools are capable of learning by experience.[14]

V.

Regardless of the controversy concerning the possible goals of monetary policy, the revival of interest in monetary techniques is a healthy development. Once again there is talk of what monetary policy can accomplish in terms of promoting stability in key economic areas such as the value of money and the volume of employment. For too long monetary policy was kept "under wraps" and subordinated to the fiscal needs of the Federal government. But the fact that monetary instruments may have been neglected in the recent past is no reason to neglect fiscal instruments in the future. Fiscal policy should not be excluded even though monetary policy is re-emphasized. The tremendous difficulties encountered in combating the depression of the 1930's and the inflation of the 1940's and early 1950's suggest that it would be undesirable to neglect either fiscal or monetary instruments in attempts to promote stability of prices and employment.

To sum up, increased interest in monetary policy necessitates a reappraisal of the possible goals of such policy. One of the central questions which must be considered in this appraisal is the relative desirability of a single policy rule or set of rules as opposed to the use of discretion by monetary authorities. While the adoption of the rule approach might remove uncertainty and some of the political aspects of policy making, this type of approach is impractical at present. If the monetary authorities were to adopt a rule relating to a major economic objective such as the level of prices or full employment, they would be unable to guarantee achievement of the rule. Their present powers are insufficient to allow them to control the volume of consumer spending. If they were to adopt a rule which they could follow, such as fixing the money supply, rigid adherence to the rule would probably make for an increased amount of eco-

[14] One way to improve monetary policy making is to improve the caliber of the membership of the Board of Governors of the Federal Reserve System. The Douglas Subcommittee made specific recommendations designed to attract able men to the Board. See report of the Subcommittee on Monetary, Credit, and Fiscal Policies of the Joint Committee on the Economic Report, Congress of the United States, 81st Congress, 2nd Session.

nomic instability. In any case, adherence to a fixed rule would prevent the monetary authorities from adapting their policies to those of the fiscal authorities. This would be unfortunate; for monetary policy is a logical complement of fiscal policy, and both are needed to promote stability in the entire economy. For these reasons, it appears desirable for the Board of Governors of the Federal Reserve System to continue to employ a high degree of discretion and skilled judgment both in the formulation and in the execution of monetary measures directed toward maintaining a large volume of employment under conditions of reasonably stable prices.

Older Workers and Their Job Effectiveness

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OLDER PEOPLE represent something of an economic problem because there are coming to be so many of them. The *problem* arises from the fact that this growing group has a diminishing economic productivity. Many people past 65 are partially or fully retired, and as a consequence, they contribute little to the national product. In 1900 there were only three million people in America 65 years of age or older, representing only 4 percent of the total population. Today there are about 13 million people in this age group, representing 8 percent of the population.[1] According to the best estimates from statisticians, the increase in the older population is bound to continue. As a matter of fact, it is believed that the number and percentage of older people will nearly double in the next 35 years. This rise in the incidence of older people is attributed to our higher standard of living and to the great strides which have been made in combating diseases.

Aside from the problem of supporting large numbers of nonproductive individuals, there is also a question as to whether healthy older citizens want to be nonproductive. Such evidence as has been assembled indicates that they do not. In one of the more reliable studies in this field, conducted by Edwin Shields Hewitt and Associates of Chicago, it was revealed that about two-thirds of persons reaching 65, who were eligible to retire with pension benefits, preferred to continue working.

In conflict with these questions is the youth-oriented philosophy of big business which customarily frowns on the employment of older applicants and smiles on the mandatory retirement of personnel who reach a certain age — usually 65. There is now a growing suspicion that these frowns and smiles are based more on fantasy than on fact, for such evidence as is being uncovered indicates that supervisors — who are in the best position to judge — look favorably on senior workers even when the efficiency of the oldster is being compared with that of the youngster.

Because there has been so much talk about the effectiveness of older workers, and so few facts offered in support, several well-known midwestern organizations were asked to cooperate with the Bureau of Business Management of the University of Illinois in a survey on the effectiveness of older industrial, retailing, office, and managerial personnel.

Three separate studies were made,[2] involving a total of 3,077 personnel 60 years of age or older (78 percent male,

[1] Figures are from an article "Profile of a Growing National Problem," *Business Week*, September 25, 1954, p. 103.

[2] Grateful acknowledgment is made to Prof. H. S. Hall, Bureau of Business Management, who participated in organizing these studies, and to the many companies whose cooperation made these studies possible.

22 percent female). The first covered 527 older workers in 22 retail stores; the second 1,525 older industrial personnel in 39 industries; and the third 1,025 older office and managerial workers in 20 organizations. The present article summarizes the findings of these studies.[3]

Survey Procedure

The studies were initiated by asking executives in cooperating organizations to determine how many employees they had on their payrolls who were 60 years of age or older. It was found that older workers constituted approximately 5 percent of the total employees in these organizations. An appropriate number of employee rating forms was then sent to each organization for distribution to supervisors, who were asked to rate each of their workers 60 years of age or older.[4]

It will be observed that in obtaining data concerning older worker effectiveness complete reliance was placed on supervisory opinion. This was because it appears that fully objective, laboratory-controlled answers cannot be obtained with reference to the effectiveness of large groups of older personnel in different types of work. It is believed that confidential evaluations of older personnel prepared by their immediate supervisors are the best indexes obtainable of older worker competence and performance.

Age of Workers and Length of Service

The average age of personnel in the survey group was approximately 64 years. The survey group was distributed into age categories as follows:

Age group	*Number of employees*	*Percent of total*
60-64	1,940	63
65-69	821	27
70-74	225	7
75 and over	91	3

The high percentage of employees in the 60-64 age group is doubtless due to the fact that in approximately one-half of the cooperating organizations there were policies in effect requiring all employees to retire at 65 or shortly thereafter.

There were several employees in the survey group who were 80 years of age. One was a tool worker who had been with his present firm for 59 years. He was given an over-all rating of "good" and was reported by his supervisor to be capable of rendering at least two more years of satisfactory service. His weaknesses were reported to be "declining eyesight and a tendency to fatigue more easily." Nevertheless, he was reported to have a better record of absenteeism and to be more dependable than average younger workers.

Another employee of 80 was a man whose work consisted of checking insurance applications. He had been employed by his company for less than a year and was rated by his supervisor as "good." It was reported that he had fewer absences than the average

[3] Each of the three studies has been published and copies of the individual reports are available upon request to the Bureau of Business Management, University of Illinois, Urbana.

[4] Supervisors were asked to rate the over-all performance of each employee and to indicate how the employee compared with *average younger workers* with regard to absenteeism, dependability, judgment, work quality, work volume, and ability to get along with others.

Age group	Rating: Excellent	Very good	Good	Fair	Poor
60-64	14%	28%	39%	17%	2%
65-69	15	27	35	20	3
70-74	12	37	33	15	3
75 and over	14	22	43	20	1

younger worker, and was as good as average younger workers in such qualities as dependability, judgment, work quality, work volume, and getting along with others. It was reported that he had no apparent age-connected weaknesses, and that it appeared he would be able to continue working for an indefinite period.

It might be expected that most of the older workers in the survey group had been with their present organizations for most of their working careers. However it was discovered that only 24 percent had spent 30 or more years with their present organization. Surprisingly, 38 percent of these older workers had been with their present organizations less than 10 years.

These figures suggest that postwar shortages in the supply of available workers have been instrumental in encouraging employing organizations to raise their age limits in employment and to seek recruits from among the older age groups. That employers were not unwise in pursuing this course is reflected in the specific findings of the survey which follow.

Supervisors' Evaluations

Over-all performance. All employees in the survey groups were given one of the following ratings by supervisors on their over-all performance: excellent, very good, good, fair, or poor. The ratings assigned by supervisors to the 3,077 older personnel in the survey group were distributed as follows: excellent, 14 percent; very good, 28 percent; good, 38 percent; fair, 18 percent; and poor, 2 percent. No important differences were noted in the ratings assigned to employees in the four age categories; while one might expect the favorableness of the ratings to decline sharply as age increased, the figures do not support such an expectation. (See tabulation above.)

There is, of course, a question as to how younger workers in these organizations would have fared in a similar evaluation of over-all performance. While no ratings of younger personnel were prepared, it seems unlikely that employees under 60 years of age would, as a group, have received ratings more favorable than those given older personnel. This is indicated by the following data in which supervisors have specifically compared the performance of older workers with that of average younger workers.

Absenteeism. Older personnel were rated by their supervisors as being much less prone to absenteeism than average younger personnel, as shown by the following ratings:

Reported to have less absenteeism	66%
Reported to have about the same absenteeism	25%
Reported to have more absenteeism	9%

There were no important differences in the ratings assigned to employees in the four age categories (60-64, 65-69, 70-74, 75 and over). Actually, the survey results show a very slight decrease in absenteeism paralleling advancing age.

Dependability. Older personnel were rated as having a high level of dependability. Fully one-half of these senior workers were regarded by their supervisors as being more dependable than average younger workers:

Reported to be more dependable.....51%
Reported to be as dependable........43%
Reported to be less dependable........6%

No important differences were found in the dependability ratings assigned to employees in the four age categories. Those in the far-advanced age groups were given ratings on dependability which compared favorably with those assigned to employees in less-advanced age groups.

Judgment. Only the office and managerial group (about one-third of the total) was rated on the element of judgment. Supervisors rated older workers, in comparison with younger workers, as follows:

Reported to have better judgment....33%
Reported about the same............57%
Reported to have poorer judgment....10%

Again, no important differences were noted in the ratings assigned to employees in the four age categories. Good judgment appears to be an enduring quality which may persist into far-advanced years.

Work quality. All older workers except those in the retailing group were rated on the quality of their work, in comparison with average younger workers, as follows:

Reported to have better work quality..34%
Reported about the same............59%
Reported to have poorer work quality...7%

A check of ratings assigned to employees in the four age groups reveals no evidence of a decline in work quality paralleling advancing years.

Work volume. A major criterion in the evaluation of an employee is productivity. In this survey the various supervisors were asked to compare the work volume of older personnel with that of average younger workers:

Reported to have a higher work volume........................24%
Reported to have a volume about the same......................56%
Reported to have a lower work volume.20%

There was a slight decline in work volume paralleling advancing years. Nevertheless, in the oldest age category (employees 75 and over), 10 percent were reported to have a higher work volume, 59 percent were reported to have a volume about the same, and 31 percent were reported to have a lower volume of work than average younger personnel. In other words, more than two-thirds of the oldest personnel in the survey group were rated as having a work volume as good as, if not better than, average younger personnel.

Getting along with others. Supervisors rated each older worker on his human relationships, in comparison with average younger workers:

Reported to get along better with others..........................32%
Reported to get along about the same..59%
Reported to get along less well with others..........................9%

No important differences were found in the ratings assigned to employees in the four age categories, thus providing no support for the traditional belief that workers present problems in human relations the older they become.

Remaining years of service. One of the most important questions asked in the study related to the number of additional years of productive service which supervisors believed older personnel would be able to give their present jobs. Supervisors were asked to write "indefinite" if an employee showed no signs of weakness or decline which suggested a specific limit on the number of years he would be able to continue working. Results showed that 26 percent of the group were rated as "indefinite." Of the remainder, the average individual was estimated to have before him approximately five and a half years of additional service.

Age-connected weaknesses. Supervisors were also asked to list any weaknesses in employees which they regarded as age-connected. They were not to list unfavorable qualities, such as inaccurate work or stubbornness, unless they considered these characteristics to be the result of advancing age. It was startling to find that 69 percent of these employees were rated "none" — indicating that they had no apparent age-connected weaknesses. Of the remainder, the weaknesses noted in order of number were general slowing down, poor health, psychological difficulties (such as forgetfulness), impaired eyesight, and impaired hearing. While the enumerated weaknesses are those commonly associated with older people in general, it is noteworthy that supervisors attributed these weaknesses to less than one-third of the older employees in this survey group.

To investigate the possibility of an age bias, the age of rating supervisors was compared with the ratings on over-all performance which supervisors assigned to their older workers. Contrary to the long-standing belief that older supervisors may tend to think more charitably of older workers than do younger supervisors, the survey results shows a surprising absence of any relationship between age of supervisor and ratings. It was found that supervisors in each age group rated their older employees with remarkable similarity.

Conclusion

The findings of this study are highly favorable to older personnel. However, the reader is cautioned to infer no more than is actually indicated. There is a suggestion, for example, that older people tend to become more efficient by virtue of their age alone. This inference, of course, is not sound because it fails to consider that the older personnel in this survey group represent a highly selective group in several senses — only those with the best apparent capabilities were selected for employment, only those with high motivation have continued to work, and only the fittest have survived dismissal.

The survey results suggest too that people 60 years of age or over should be selected for employment in preference to younger people. However, this inference is also unsound because it overlooks the necessity in business organizations of employing younger per-

sons who will be able to give long years of experienced service to the organization and who will be available to replace senior workers who must ultimately leave the organization. It also overlooks the complications that employment of older persons may pose for a firm's pension system.

The findings of the survey do, however, support the following conclusions:

1. Supervisors in business and industry consider a majority of their workers 60 years of age or older to be as good as, or superior to, average younger workers with reference to absenteeism, dependability, judgment, work quality, work volume, and human relations.
2. There is no specific point of age at which employees become unproductive. Supervisors indicate by their ratings that satisfactory work performance may continue into the eighth decade.
3. Supervisors indicate by their ratings that organizations which require employees to retire at a certain age, such as 65, are losing a great deal of valuable productivity.
4. Supervisors believe that about one-quarter of their workers 60 years of age or older will be able to continue working indefinitely.
5. Supervisors believe that a majority of their workers 60 years of age or older have no apparent and specific age-connected weaknesses.
6. Supervisors have had generally favorable results with new employees recruited from the ranks of the middle-aged. The fact that 38 percent of the employees in this survey group have been with their present organizations less than ten years means that these persons must have been hired when past 50 years of age.
7. There is no indication that the age of the supervisor has anything to do with the favorableness of ratings assigned to older workers.

Management need not be magnanimous about utilizing older people. There is a growing and imposing assembly of evidence that older workers as a group are productive and competent — even when their performance is compared with that of average younger workers.

Factors Affecting Private United States Investment in Japan

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The almost continuous Japanese trade deficits since 1945 have been made possible by "abnormal" foreign exchange receipts — American aid, United Nations "special procurement," maintenance of United States troops in Japan, and spending by United States troops. The gradual decline in these receipts is creating increased interest in means of improving Japan's balance of payments position.

One method is to import foreign capital and technology as means of increasing the efficiency of the Japanese industrial plant. This investment of funds and know-how can improve Japan's balance of payments position (1) by enabling Japan to produce substitute products for her imports and use her raw material imports more efficiently, thereby cutting import requirements, and (2) by decreasing costs and prices of Japanese exports which, in turn, should increase exports. The predominant supplier of both technology and capital in postwar Japan has been the United States.

In an effort to determine the more important factors which affect this means of improving Japan's balance of payments position, questionnaires were sent in the summer of 1954 to private United States investors in Japan asking what considerations had affected favorably or unfavorably their decisions to invest in Japan.[1] Replies were received from half of the 54 investors contained in the Bank of Japan's *List of Principal Cases of Foreign Capital Investment,* which lists practically all foreign investors in Japanese stocks involving participation in management. A few other replies were used such as the returns from a Canadian investor whose investments are handled by a United States firm, replies from two investors omitted in the Bank's list, and the second replies from investors having more than one interest in Japan. This brought the total number of replies used to 32. The inquiry represents 61 percent of those investing more than $100,000 and 44 percent of the smaller investors. The oil industry, which has accounted for almost 60 percent of American postwar investment in Japan, was represented by only one respondent out of four investing companies. Neglecting this industry the replies represent 77 percent of the total United States investment in Japanese stocks which provide for participation in management.

The influence which replies from the non-respondents might have on the conclusions is not known, and likewise, the views of the American investors

[1] The author made the survey under the supervision and sponsorship of the Bureau of Economic and Business Research, University of Illinois.

who considered and rejected investment in Japan are not known.

Types of Investment

As a background for study of the factors which affect investment decisions, it might be well to note the character of American investments in Japan. First, they are direct rather than portfolio investments. The investments involve ownership, control, and management of the Japanese companies. Even in the case of loans, which are generally considered portfolio investments, the stock interests of the American investor in the Japanese company have usually been sufficient to provide these elements of ownership and management in the firm. Second, despite the fact that in theory anyone can invest, the American investor in Japan is primarily the large corporate investor. Only a few of the minor investments were made by individuals, and many of the investments listed under names of individuals represent combinations, investment houses, and so forth. Next, the investor is an experienced foreign investor. Of the firms in the study all but four had other foreign commitments and the majority had less than one-fourth of their overseas investments in Japan. In 12 instances the investor had investments in Japanese firms in the prewar period, and hence was not only experienced in international investment, but in this specific area as well.

Unlike much of United States foreign investment, which has been in the raw materials producing industries providing exports to the United States and elsewhere, American investment in Japan has not been in these industries. Because of the scarcity of natural resources, Japan is dependent in large measure on the earnings from industry and trade, and these are the fields in which United States investors have been most interested. Of the 30 investors included in this study, 23 were engaged in manufacturing, 10 in sales and distribution, and 5 in services. Only one investor had invested in mining. Several investors were, of course, engaged in more than one form of activity. Those engaged in manufacturing appeared to be producing goods primarily for the Japanese market and to a lesser extent for the other Asiatic markets, rather than for export to the United States. Although almost 60 percent of the investment has been in petroleum, it has been in refining and distribution facilities needed for domestic use of crude imports rather than for extraction of oil for export, as is true in many cases of United States investment abroad.

The replies indicated that, by and large, the American investor considers investment experience in Japan about as satisfactory as that in other foreign countries except Canada. The feeling that investment experience had been less satisfactory was not characteristic of any one industry, but, rather, appeared to result from matters affecting the individual investor. Similarly, the larger group which considered its investment experience more satisfactory was not limited to certain industries. However, this group represented larger investments in general. The one reply from the oil industry indicated that the

company's experience in Japan had been more satisfactory than elsewhere. While one reply can hardly be considered representative of the four United States investors in the oil industry, the large amounts invested by American oil companies in postwar Japan may indicate that these investors consider their investment experience to have been at least as satisfactory as their other investments abroad.

Additional evidence that American investors think their investment experience has been satisfactory is derived from the fact that only one of the firms having completed the required two-year holding period had repatriated any of its original investment. Still more conclusive was the fact that almost half the investors answering the questionnaire reported that they expected to increase their capital investment in Japan during the next year.

Not all American investors have provided Japan with disposable dollar exchange. In 40 percent of the instances, the United States firm had made its stock investment entirely with dollars, but in a fourth of the cases the entire investment had been made by giving technical assistance to the Japanese firm. All replying firms with investments in the chemical industry were in this category. One investment was made by furnishing machinery to the Japanese company. The remaining investors had used combinations of these means, salable merchandise, and reinvested earnings to make their investments.

It seems that American investors in postwar Japan are primarily direct investors, large corporate investors, experienced investors, investors in manufacturing and trade, and, by and large, satisfied investors. In addition, a number of American investors did not make their investments entirely in dollars, and most supplied technical assistance as well as funds.

Favorable Factors

The study indicated that by far the most important favorable influence on the decision to invest was the market potential in Japan, for more than one-half of the investors mentioned this factor in one form or another. Two of the typical replies on this subject (and the industry represented) are quoted here:

> Belief that Japan will regain its position as the workshop of the Far East . . . (Foreign trade)
>
> Opportunity to participate in a growth industry in a growth nation. (Electrical)

The importance of this factor is readily understandable. The investors are almost all business enterprises interested in expanding their domestic operations to Japan, and a market for their product is the first requisite.

The favorable factor next in importance appeared to be the respect for and confidence in the Japanese which the United States investors had. A typical reply falling into this category follows:

> Production, sale and application engineering of our equipment required high-grade and well trained engineers. We were fortunate to become acquainted with a group of such engineers in Japan. The confidence we had in these engineers has been completely justified through the years of cooperation with them. (Machinery)

While it might be said that very few investors would invest on the basis of this factor alone, it might also be said that very few will make large commitments without confidence in and respect for those with whom the investor expects to be associated.

A third consideration was the importance of investment in Japan when the investor's world-wide operations were considered:

> Good replacement for our facilities in Shanghai lost to Reds. (Chemicals)

> The investments were maintained in line with this corporation's policy to have . . . equipment manufacturing companies in the principal countries of the world. (Electrical)

> . . . we never voluntarily leave a country once we have established ourselves therein. (Machinery)

Another factor of some importance was the availability of efficient, low-cost labor:

> It was . . . obvious that we could not compete in Japan with the prices offered by European manufacturers. Considering the low labor rate in Japan, the only way to supply the Japanese market was and is to manufacture in Japan. (Machinery)

Possibly more investors would have mentioned low-cost labor as a factor, if it were not that high raw material costs and inefficient fabricating methods in many areas more than offset the economies resulting from low wage rates.

In several instances the American investors were approached directly by Japanese businessmen or by the Japanese Government:

> We were requested by the Japanese Government with the endorsement of our State Department to cooperate by licensing a Japanese manufacturer to produce our equipment as a means of modernizing the Japanese National Railways. (Machinery)

This participation of the Japanese Government is illustrative of the prominent role it has played in postwar foreign investment in Japan. Not only does it refuse validation for investments believed not to be in the country's interests, but it actively seeks investors in areas where foreign investment and technical assistance are deemed necessary.

There were a large number of miscellaneous factors given for deciding to invest in Japan. Some are applicable only to the individual investor and many are secondary reasons for investing:

> . . . use of equipment which became obsolete in the USA. (Spinning)

> . . . ability to gain substantial position without converting United States dollars. (Chemicals)

> . . . for political reasons . . . (Services)

> This company is servicing [equipment] belonging to us. We desired to have some control over their technical standards. (Services)

> We . . . felt that direct cooperation would probably better protect our interest in our own designs than a negative attitude which would lead to copying. (Machinery)

Investors were also asked what favorable factors, if any, had developed after their original investment was made. Since investments were originally made from 1905 to 1954, the later developments varied considerably with the individual investors. Inasmuch as many have invested relatively recently it is understandable that more than a fourth of the firms replied that it was too early to judge what new factors, if any,

were affecting most favorably their investments in Japan.

After the original investment was made, the cooperation and satisfactory performance of the Japanese firm was the fact mentioned most often:

> We have found our Japanese associates of the highest caliber and integrity . . . (Machinery)

> . . . excellent management, conservative operation and intelligent expansion of the business. (Foreign trade)

The personal relationship between American investor and Japanese management seems to be of considerable importance.

Once the original investment was made, one of the most important favorable factors was, as might be expected, the financial results:

> We grew like "Topsy." (Lumber)

> Dividends have been forthcoming in U. S. dollars at an attractive rate. (Electrical)

The author was somewhat surprised that this factor was not mentioned most often, but it may be that many of the firms were recent investors having long-term investment and considering it too early to evaluate the financial results satisfactorily.

Some of the activities of the Japanese Government proved to be a favorable factor:

> During the course of negotiating our agreement, the Japanese Government approved the payment in dollars of royalties, and payments have been coming through regularly without any trouble. (Chemicals)

While this section dealt with favorable factors after the original investment was made, many of the replies referred to favorable considerations which did not necessarily develop after the investments were made.

Two investors felt the continued support of Japan by the United States was a factor which would favorably affect their decisions concerning continuation of investment in Japan.

In summary, replies in the study seem to indicate that the favorable factors of greatest importance when the decision to invest was made were (in order of importance) market potential, respect for and confidence in the Japanese, established company policies of the investors, Japan's low-cost, efficient labor, and the fact that the investor was approached by Japanese businessmen or by the Japanese Government. After the American investor had entered Japan, the satisfactory performance of the Japanese firm and its profit rate were favorable factors of greatest importance.

Unfavorable Factors

The National Industrial Conference Board indicated in a report prepared in 1952 for the President's Committee for Financing Foreign Trade that the three most important obstacles to direct foreign investment both on a world-wide basis and in Asia were export-import quotas, restrictions on the remittance of earnings abroad, and restrictions on capital movement in and out of the foreign country. Probably these obstacles apply to Japan, but the Board's sample was inadequate to determine the unfavorable factors specifically affecting private United States investment in Japan.

The Office of International Trade, Department of Commerce, found in 1953 that some of the obstacles in the Far East included the threat of invasion and internal disturbance, the newness of the governments; the inadequacy of information necessary for investment decisions; the existence of rigid controls; and the low level of average incomes. These factors would in most cases apply to Japan in some degree, but are not necessarily in order of importance.

In the current study respondents were asked what factors were considered unfavorable at the time the original investment was made. The most frequently mentioned unfavorable factors were the foreign exchange controls which were mentioned seven times:

> The most unfavorable factor has been the Foreign Investment Law of Japan which compels the investor to maintain his investment intact for a period of two years, whereafter he can only repatriate the proceeds of the sale of 20% of the original investment per annum. Inflexibility in the law so that the investor may not switch his holdings from one security to another during the two year holding period without loss of seniority. This immobility of capital is probably by far the greatest deterrent to investment in Japan. . . . (Foreign trade)

Since most of the investors have invested or increased their investment since these controls have been in effect, they were, at least, forewarned of these difficulties and apparently decided to invest despite such restrictions.

Closely related to the first unfavorable factor of foreign exchange controls was the unfavorable balance of trade position which has forced the imposition of import quotas. Japan's inability or unwillingness to balance her trade account directly affects the prospects which investors have of repatriating their investments. In some cases the balance of payments position affects the quantities of raw materials which can be imported by the subsidiary, thus affecting the possibility of successful operation in Japan whether or not earnings are repatriated. Taken together the foreign exchange regulations and the balance of payments position were overwhelmingly the most important deterrents to investment.

A third factor of importance was the scarcity and high prices of raw materials and the accompanying high costs of production:

> Precarious sources of raw materials (bauxite from Indonesia and Malaya). (Metals)

> High costs of production and the high prices of raw material were unfavorable factors for the long run. (Machinery)

The reasons for high costs of production were not clear, but presumably refer to materials costs and inefficient fabrication methods.

Another factor considered was Japan's closeness to Communist territory:

> Uncertainty about the political future of Japan in close proximity to the USSR . . . (Electrical)

> We . . . recognize the risk inherent in any substantial capital investment in Japan due to its geographical location . . . (Machinery)

Closely allied to this consideration was uncertainty on the part of two investors as to Japan's political future.

Two investors said that tax dis-

crimination influenced their decision to invest. The investors mentioning this factor did not say whether they were referring to the 5 percent "family corporation" tax imposed on a Japanese subsidiary of a United States company or to discriminatory enforcement of the tax laws. One investor commented, "If properly handled the tax problem can be dealt with although it is a considerable item." Tax discrimination did not, however, seem to be a serious deterrent to private United States investment.

The replying investors also listed unfavorable factors affecting their interests which had developed since the original investment. Here the most frequent factor mentioned was Japan's unstable economic situation and continued inflation during the last two years:

> Lack of stability in . . . currency. (Petroleum)

> Economic situation in Japan plus unstable Far Eastern situation. (Chemicals)

Most of the other unfavorable factors developing after investment followed along the lines of those originally anticipated. Several comments on the experiences of individual investors are well worth noting:

> Lack of Japanese capital to carry out their commitments. (Metal)

> The Japanese Company has continuously been confronted with financial difficulties. Payments by their customers, even the large industrial firms, are very slow and interests on loans are between 10 and 15%. (Machinery)

> Inability to reproduce quality of American and European [merchandise] even in 1954. (Lumber)

> Government restrictions on increasing capitalization of U. S. registered funds has slowed the development of our activities. (Machinery)

> I do not encourage private U. S. investment in Japan because of laxity in enforcing patent rights by the Japanese government. My [products] are patented in Japan but, payments of royalties due me are never made. Many Japanese firms copy foreign patented products and sells [sic] them cheaper than genuine goods. As a whole payments for products and services rendered are very bad. (Tile)

Although only two investors mentioned the "limitations set by the Japanese Government on the transferability of dividends on prewar investments in Japan," it is certainly an unfavorable factor. These prewar investors must apply periodically to the Ministry of Finance for permission to remit abroad their profits and if this permission is granted a percentage (usually less than half) of the earnings may be remitted. Not only may the yen earnings not be remitted in some cases, but they also cannot be invested in any other Japanese enterprise. Thus, foreign investors must use their ingenuity to reinvest their earnings profitably by expanding manufacturing facilities, increasing sales promotion, enlarging research programs, and the like.

In summary, investors covered in this survey considered stringent foreign exchange controls, the unfavorable balance of trade position, the scarcity and high costs of raw materials and the high costs of production, and Japan's proximity to Communist territory as the more important deterrents to investment in Japan. After respondents had made their original investments,

the unstable economic situation and continuing inflation were considered to be unfavorable factors affecting their investments.

Proposals for Increasing Investments

The National Industrial Conference Board's report on obstacles to direct foreign investment indicated that tax concessions were the most frequent suggestions from businessmen for increasing foreign investment, and numerous speeches by prominent business leaders have made this point.

The United States Department of Commerce has mentioned especially that consideration should be given to proposed revisions in the tax credit system designed to prevent tax concessions made by a foreign government from resulting merely in higher United States taxes.[2] Other proposals have been made, including: Broaden the definition of and remove limitations on credit received for foreign taxes; extend to the rest of the world tax privileges now enjoyed by Western Hemisphere trade corporations; grant the privilege of deferring taxes on income of foreign branches until the income is repatriated to the United States; and provide for rapid write-off of international investments.

The present study supports the findings of these two studies in that replies indicated that tax relief either by the Japanese Government or by the American Government or by both was the most common proposal which businessmen had for encouraging private United States investment in Japan. Walter H. Diamond, editor of the McGraw-Hill "American Letter," said in an address to the Institute of International Trade, University of Illinois, "A 42% corporation tax, a 12% local Enterprise levy, a 12½% Municipal Inhabitants Tax, a ½ to 3% net worth tax and a 5% 'family corporation' tax imposed on a Japanese subsidiary of a U. S. company makes investing in Japan a heavy burden."[3] While respondents frequently did not specify whether they were concerned most with United States taxes or Japanese taxes, it appeared that they were probably most concerned with United States taxes. A step in the direction of lower taxes was the signing, in April, 1954, of two treaties between the United States and Japan for the purpose of eliminating double taxation. Under the treaty provisions Federal taxes in one country will be allowed as a credit in the other nation. The greatest objection to many of the proposals advanced is, of course, that such concessions might result in greater profit after taxes to present foreign investors without a proportionate increase in direct foreign investment.

Respondents indicated that fewer controls and less red tape would be almost equal in importance to lower taxes as a means of increasing investments:

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[2] United States Department of Commerce, Office of International Trade, *Study of Factors Limiting American Private Foreign Investment, Summary of Preliminary Findings and Recommendations* (Washington: Government Printing Office, 1953), p. 27.

[3] Held at Monticello, Illinois, in June, 1954. See "Foreign Areas Attractive For American Investments," *Commercial and Financial Chronicle,* July 1, 1954, p. 1.

Streamlining of the vast unnecessary bureaucracy in the Japanese Government would be a signal encouragement to investing and doing business in Japan. (Electrical)

There were some respondents who considered Japan's present policies with respect to foreign investment reasonable and understandable:

It is our opinion that no additional proposals are required to encourage private U. S. investment in Japan, as long as the Japanese Government adheres in good faith to the present laws and regulations governing such investments, except ratification of the reciprocal tax agreement which has been drafted and is under consideration by the respective Governments. (Electrical)

Japanese Gov't should continue supervision and approval of investment agreements . . . [and] continue preference to industries supporting export trade. (Chemicals)

Thus, businessmen's proposals for stimulating investment seemed to follow along two lines of almost equal importance: (1) tax concessions and (2) reduced restrictions on foreign investment.

The study leads to some possible inferences regarding the Japanese Government's policy toward foreign investment. First, it seems that Japan intends to ensure domestic control of the industries receiving foreign capital. Only in the petroleum industry have there been indications of foreign domination of a domestic industry, and here, in any case, Japan must depend on crude imports controlled by foreign interests.

Second, while the individual investor usually looks upon investment in Japan as a means of expanding his market, the Japanese Government looks upon foreign investment as a means of improving its balance of payments position and has consistently permitted only those foreign investments which will improve directly or indirectly this position.

Third, the restrictions and taxes on foreign investment have hindered private United States investment in Japan. Should the Japanese Government consider additional foreign investment desirable under these circumstances, it might grant tax concessions and modify its controls on foreign investment as means of stimulating foreign investment.

Fourth, it seems likely that any improvement in the Japanese balance of payments position will encourage foreign investment, which, in turn should improve the balance of payments position. The balance of payments and foreign investment are not separate, independent problems, but two mutually dependent and interrelated factors in Japan's economy. An improvement in either factor is likely to help the other and thus have a cumulative, "snowball" effect in improving Japan's economic position.

Should a Company Publish Its History?

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WHETHER Henry Ford ever said "history is the bunk" is much less important than the rather sinister implications that this statement and hundreds of others like it leave in the minds of the average person. "History" to the typical American, conditioned as he is to rapid change, calls to mind his high school history teacher tonelessly recounting the dates of the battles of the Civil War, or possibly the picture of a mouselike college professor sitting in his ivory tower religiously poring over books of great intellectual and physical weight.

In reality this is far from the truth, both for the field of history as a whole and for a relatively new and exciting branch, business history. If study of history were based solely on the desire to explore the past as an intellectual pursuit, we might find an almost universal agreement by businessmen that such a hobby was truly a "sport of kings" to be indulged in only by those who were already living off the proceeds of their first million. But if the study of history were used not only for the laudable but "impractical" uses above but also to relate the past to the present and the future, to provide not only facts but perspective, and to amass additional bulwarks to be used together with contemporary information as guides for future action, we might find considerable backing for such an approach among men of action.

In many respects the field of business history is uniquely qualified to achieve these important goals. The lives of business firms have fared none too well in the past when transferred to the printed word, and in a number of cases a lack of facts and perspective has been evidenced to the detriment of both the public relations of the firms and, more seriously, the understanding of the governmental policy makers, the educators, the young people, the businessmen themselves, and most of the rest of the groups that make up the "general public."[1] Recent approaches in the field of business history, however, have been based on a stronger portion of both business cooperation and objective facts, and in turn have opened new doors to public understanding of business.

What Is Business History?

In the general sense, *any* history has in it elements of business history. Political history, cultural history, social history all draw from business to support their theses. But all of these approaches to "business" study are not business

[1] The muckraking period of the late nineteenth and early twentieth centuries would rank high in this respect (see Ida Tarbell's history of the Standard Oil Company, Lincoln Steffen's "exposés" in *McClures Magazine,* and Upton Sinclair's novel of the Chicago stockyards, *The Jungle*). But such writings have been present throughout the history of American business.

history, and for a very patricular reason.

A common feature found in all of these types of history is that business is studied essentially as a total entity, or at least in large segments made up of a number of individual units. The economic, political, cultural, or social historian dips into the individual business unit only to find one aspect of a total theory. At least from the standpoint of the use of facts of *business*, this is essentially a deductive approach. The business analyst, on the other hand, builds from the individual business unit (or industry) in an attempt to complement the more deductive approach of these other historians. Four separate approaches can be used.

First, a business history can cover the "life" of a single business firm. This can range from the study of a small single proprietorship to the study of large business units and complicated holding companies. To date, the major proportion of histories have been concerned with individual firms.[2]

Closely allied to the history of a firm, and in many cases synonymous with the firm's history, is the business biography. Here the history is that of the life of an individual. If the individual is functional in more than one business, each of these is chronicled, and the personal life of the individual often forms a major part of the history. Many businesses are essentially extensions of an individual's personality, and a biography may be the most logical form for the history of the business as such.

Because of certain shortcomings in the methods and results of business biography, a separate "inter-disciplinary" approach has recently been initiated to study "entrepreneurial history." The field is conceived of as being much wider in scope than business biography, with a shift in emphasis away from the firm and the individual alone and toward the larger social role of entrepreneurship.[3]

A third field of business history is the study of an industry — a group of business firms producing essentially the same goods or services and competing with each other. If a broad definition is taken of an "industry study," the field has already been extensively explored. Research in economic history and theory has embraced a number of such studies. Several governmental studies, particularly those of the Temporary National Economic Committee, have

[2] Because of the concentration of volume here at the level of the individual firm, no short listing of published histories could do justice to all. The work of the Harvard University business history group would perhaps be a logical point of departure. Studies published to date include, for example, histories of the Pepperell Manufacturing Company, Reed and Barton, N. W. Ayer and Son, and R. H. Macy and Company. Possibly the best single bibliography of published business histories is the monumental work by Henrietta M. Larson, *Guide to Business History* (Cambridge: Harvard University Press, 1950.)

[3] The formal initiation came through a Rockefeller Foundation grant in 1948 making funds available to form a Research Center in Entrepreneurial History, located at Harvard University. The Center and its associates have to the present been concerned with five major areas of research: (1) innovation and change as affected by the entrepreneur; (2) origins of entrepreneurs; (3) the businessman's conception of the entrepreneurial function; (4) international differences in entrepreneurship; and (5) sociological implications of entrepreneurship.

approached full-scale industry studies.[4] Industry trade associations have also been active in certain phases of industry research. Most of the research by these various groups has been confined to particular aspects of the industry, and to date, few full-scale *industry histories* have been attempted. As the writing of individual business unit histories is an almost essential prelude to such an industry history, this field will necessarily broaden in scope only at such a time as a requisite number of studies of individual units have been made available.

The fourth type is truly in its infancy — the general business history. Just as the industry history is dependent to a considerable degree on previous study of the individual units, the general business history is dependent on previous work, and general business histories will probably not be written until both firm and industry histories become more numerous.[5]

The Objectives of a Business History

The economics of both research and publishing would seem to dictate the necessity for "readership" of business histories, so we might ask "Why are business histories written?"

A natural recipient of the fruits of business history is the industry, firm, or individual on which the research is done. But some of the specific benefits are themselves not quite so obvious. Naturally the advertising and employee relations values of a well-written factual business history are sizable. An account of the history of an enterprise, in a factual proportion of "good" and "bad," can go far to dispel the inaccuracies of previous works, whichever direction these inaccuracies have taken.

As mentioned earlier, however, the use of the past to aid in interpretation of the present and the future, to gain perspective and a realization of the pervasiveness of change, is in most cases much more fundamental. Often the business firm will use the history as an accurate and concise record preservation device. A professional approach to a firm history should exert a salutary influence on the attempt to professionalize the management of a firm, for properly interpreted past facts can often prevent repetition of past mistakes. A history of a firm may be a powerful tool in aiding in the development of a service concept of business management — a stewardship function in addition to that of profit making. If put to such uses, a business history can become a major management tool.

Benefits of business history extend much further than that of the business firm alone. The field of education, particularly education for business, can greatly profit from study of business histories. An element of reality that should accrue to the benefit of educational theory is injected into teaching through vicarious business experience and insight into the programs and methods of business.

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[4] See Joe S. Bain, "Price and Production Policies," in Howard S. Ellis, *A Survey of Contemporary Economics,* I (Philadelphia: The Blakiston Company, 1949), 129-73.

[5] Two pioneer works are available, however: Thomas C. Cochran and William Miller, *The Age of Enterprise* (New York: The Macmillan Company, 1951); N. S. B. Gras, *Business and Capitalism* (New York: F. S. Crofts and Company, 1947).

Last, business history provides certain intangible but nonetheless important benefits to the general public. It is impossible to assess the impact of the General Motors Corporation or the United States Steel Corporation on America or the world, but certainly the influence of businesses, large and small, is of major importance to society. Knowledge of the factual forces behind such enterprises can go far to provide society with its own necessary perspective.

Writing a Business History

Who?

"Anyone who is competent" can write a business history, but this is begging the question.

A member of the firm is often chosen to "tell the company's story." Typically, he would be an advertising man, the secretary, the public relations man, or a member of the personnel staff. Each has points of strength, but generally none has the breadth of perspective to assess adequately the entire organization. If they were to combine, and if each member rendered a well-rounded product, an adequate history could be written. This is a "large order" and is seldom achieved.[6]

Second, a commercial free lance writer may be summoned. Many are available, and on occasion, good histories have resulted. However, a lack of impartiality is always a potential threat, for one hates to "bite the hand that is feeding one." This obstacle, and others like it, can be overcome and a useful history compiled, particularly if the writer has had wide experience in such work.

The third avenue is quite similar. Often an advertising agency is employed rather than an individual. The same difficulties of the first two approaches are often present, together with an inherent tendency to "advertise" the company rather than provide a factual and rounded history. The two concepts are not synonymous. Great fires experienced by the company are certainly more exciting than the financial structure, but not always more important.

An independent journalist might be chosen, and the problems of potentially excessive influence by the company mitigated in the process. A more serious danger is present, however. The journalist is keyed to the interest of the public *at the time he is writing,* and the major objective is to produce a document that will be read. In other words, the popularity of his writing is not determined by how true or fundamental his facts are, but whether the work fits the particular mores of the particular period. This is not necessarily business history.

In truth, the field of endeavor of the writer is unimportant; rather, the particular abilities of the writer as a business historian should be the deciding criteria. He should be well trained in one or more basic functions of business, such as production, finance, or sales. He should have a sense of history, but not such an amount of work in a field of history as to become wedded to a historical method of thinking. He

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[6] For a discussion of some of the "roadblocks," see Ralph W. Hidy, "Problems in Collaborative Writing of Business History," *Bulletin of the Business Historical Society,* XXIII, No. 2 (June, 1949), 67-77.

should have a consuming interest in business, an interest that is not colored by a negative or positive bias. Lastly, he should be able to express himself both orally and in writing. For if no one will listen to him in the process of compilation, he will not get the facts, and if no one reads his results, he has wasted many peoples' time and money.

What Is in a Business History?

There are several frames of reference which may be used in writing a business history. Each has its place. None should be overemphasized to the exclusion of other segments relevant to the particular firm. One or more of the following aspects of a business might be covered: (1) the position of the firm in the industry; (2) a particular function in the firm (e.g., a "marketing" history); (3) organizational structure; (4) policy formulation; (5) execution of policy and methods of operation; (6) product development and research; (7) plant, equipment, and technology.

The best approach would be utilization of all these viewpoints that are present and relevant to the particular firm. This cannot always be accomplished, either from the standpoint of the extreme breadth and depth of the combination or from the frequent lack of full information in one or more of the areas.

How Does One Write a Business History?

Just what resources should a researcher have available to him in order to write a business history? A specific list of sources for an individual firm would, of necessity, depend on the type and extent of records maintained by the firm. If there is a fundamental lack of records and documents available, the history should not be written. In actual fact, however, there will never be present *all* records desired by the writer; some gaps will undoubtedly exist.[7]

In addition to physical presence of records, these records must be fully available to the writer, together with the opportunity for access to individuals in the firm for personal interviews. Very little compromise can be made on this point, for skeletons remaining in the closet will forever haunt a history. It is not, however, mandatory to exhibit for public consumption all such skeletons. Certainly one would not advocate publishing an unfavorable fact about an individual, a fact that might cause considerable embarrassment, unless this fact were necessary to portray accurately the company's history. But an impartial scholar would not care to be associated with a published piece that omitted material facts.

Some Concluding Observations

In sum, it would appear that the business history, properly conceived and adequately executed, offers a unique opportunity to management. Alone, the economic information made

[7] Two excellent sources for guides to proper record preservation are Ralph M. Hower, "The Preservation of Business Records," *Supplement to Bulletin of the Business Historical Society,* 1940, and Irving P. Schiller, "A Program for the Management of Business Records," *Bulletin of the Business Historical Society,* XXI, No. 2 (April, 1947), 44-48.

available to educators and the public by such a study could well justify the expense and time involved. When the potential for internal use in management planning and control is added, the values may be far beyond these costs.

By the nature of the type of study, however, this is specifically an opportunity *for management*. The social or economic historian can sit beside large forces and effects, observe these forces and effects as a "spectator," and then compile a useful and relevant overview. The business historian, on the other hand, must write *within* the framework of the individual firm. Certainly the problem of monetary support is important, but this is not peculiar to the business historian — all research work requires a sound financial base. But the business historian does have a problem that is perhaps more acute than in other areas of research — he needs entry into and cooperation from the firm. Here is the necessary first knob of the series of doors management may open through the writing of a business history. Once opened, these doors may lead the way to an increasingly valuable tool in the kit of management techniques.

The Operation of Communist Banks

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DURING THE 1920's and 1930's, the Soviet banking system evolved from the capitalist system which had developed in the Czarist days. In the course of its evolution it succeeded in adapting the operation, technique, and theory of capitalist banking to the special requirements of a centrally controlled economy. It acquired additionally some new and interesting functions, the exercise of which is possible, and indeed necessary, only in the peculiar environment of Communist banking. The new mode of functioning of banks is being transferred to the banking systems of the satellite countries, spreading out from the USSR and wielding an increasing influence. A study of this new system and of its operation is rewarding in greater understanding of the functioning of the whole Communist economy, of which the banking system constitutes an important part.

Contrasts with Capitalist Banks

Communist banks are state - owned and are run not for profit but so as to further the interests of the state. In this, the banks do not act according to their separate understandings of the economic situation and the needs of the moment, but follow strictly the economic plan drawn up by the government central planning body. The banks have virtually no freedom of action — their functioning is reduced to the administration of the plan and to its enforcement. By virtue of this fact, the actions of the particular banks are centrally regulated and coordinated.

The function of money creation belongs only to one bank, the central bank of the country. The other banks cannot create deposits by extending loans through crediting the customer on their books. Instead, they can operate solely with the funds that have been remitted to them in one way or another: through deposits or budget grants. Consequently, the central bank with its numerous branches performs the role in which, under capitalism, are engaged most of the banking institutions.

All economic enterprises and organizations are compelled by law to hold an open deposit account with the central bank. Through this account all payments above a stated minimum amount are transacted, the process of clearing being performed by the central bank with its branches throughout the country. Two main results of the adoption of such a system are: (1) Most of the transactions which take place in a Communist country are done by bookkeeping transfers from one account to another, within the same central bank. Whereas in the West such transfers are accomplished by means of checks (which may be endorsed and put into further circulation), payments under Communism are made in the form of *giro* transfers, i.e., instructions to the central bank to debit the account of the payer and credit the account of the

payee. (2) In this way each transaction may be traced in the books of the central bank, which thus maintains constant control over all, or almost all, the activities of economic organizations. One element of that control is through the scrutiny of the payments made by the economic unit, all of which have to be accounted for in accordance with the plan.

Short-term loans are made almost exclusively by the central bank. These loans serve to finance current production and the carrying of inventories, and are closely connected with fluctuations in the working capital of the enterprises. Each loan is given to finance a particular purchase of raw materials, wage payments, or other cost involved in production and distribution. Once the product is sold, the loan has to be repaid, another loan being granted to finance further production. The central bank, while extending its short-term loans, can thus keep a close control over the productive processes performed by its clients, over the quantities of raw materials purchased, wages paid out, and so forth.

Long-term credits, on the other hand, are given by specialized investment banks, few in number, and with a strict division of functions. In the USSR there are four such long-term banks servicing respectively the industrial, the municipal, the trade and cooperative, and the agricultural sectors of the economy. Their credits are given usually in the form of grants, and the banks are required only to ascertain that the funds passed on are spent according to the directives of the economic plan of the planners. The function of the long-term investment banks is, again, control over the financing of investments. In contrast with capitalist banking, the Communist long-term credit field is monopolized by a few banks, functionally divided between those banks, conducted as a rule on a nonrepayment basis, and rigidly controlled.

Collection of savings from private individuals is also monopolized by a special savings bank which invests in government bonds the funds thus gathered.

Operations concerning foreign exchange are the monopoly of the central bank which delegates the technical side of those operations to a special bank for foreign trade. The operations of the latter are controlled by the central bank.

The Communist central bank does not fulfill the role of the lender of last resort. The investment banks operate with funds obtained by them either in the form of government grants or in deposits in the depreciation account by the enterprises, i.e., they do not create net bank credit. Hence they never find themselves with depleted reserves and in need of borrowing. The brunt of the country's fluctuations in the demand for cash is borne by the branches of the central bank, and movement of cash between the main office and branches of that bank belongs to the internal affairs of the central bank. The institutional developments in Communist banking have therefore eliminated the need for a lender of last resort.

Differences in the operation of Communist banks as compared with capitalist banks are based on some fundamental factors found in the economic environment of the banking system. A more detailed discussion of the operation of this system is offered *infra.*

Background of Communist Banking

It may be desirable to consider the difference between the free market system and the planned economic system. In the former, unfettered market forces of supply and demand direct the economy in a way which is usually described as being the expression of "consumers' sovereignty." Consumers and businessmen are, both singly and aggregatively, guided in their decisions by private motives, without regard for the possible social and general economic repercussions of their actions. Under the planned economic system, on the other hand, market forces are eliminated — at least partially — as undesirable and unable to bring about the optimum rate of development of the productive potential of the country. It is also contended by some writers that market forces move the economy in a haphazard and for all practical purposes undirected way, which is alien to the conception of a rational society. The planned economic system substitutes, therefore, planning for market forces and regulations for *laissez faire*. The planned system works consciously to ensure full utilization of resources, whereas a free economic system does not safeguard the achievement of full employment because of the blind operation of market forces.

This planned full employment policy imposes on the financial system the burden of backing up the demand of the state for goods and services with sufficient purchasing power. Insufficiency of monetary media in the hands of the state would result in the impossibility of attaining full employment. On the other hand, overabundance of purchasing power created by the banking system and put into the hands of the state would resolve itself in inflationary conditions, with the state bidding for more resources than were free for its use.

The Communist state tries to employ most of the resources for its own purposes — which means in practice bidding them away from private consumers. If it is deemed inadvisable to take the "superfluous" purchasing power from the hands of the consumers by means of direct or indirect taxation, and if the state insists on its own purchase program, then the banking system — being a servant of the state — has to create additional money to enable the state to fulfill its plan. But the use of this new money bids up the prices of goods and services, and the country promptly finds itself in the snares of inflation. The banks have no real independence in the matter. They act as a mute arm of the government, and inflation is caused by the latter's economic policy.

Most of the Communist countries were at the start, or are still, virtually undeveloped economies, with agriculture playing the predominant role. The ambition of those countries is to industrialize quickly, and they stoically and doggedly set about realizing this ambition. The results of such a policy are that: (a) there is a pronounced movement of population from the country to the towns, with the accompanying necessity for greater education and professional instruction for operatives, all of which results in some social friction; (b) various bottlenecks appear when

the pool of hidden agricultural unemployment becomes exhausted, when houses have to be built on a large scale for the people attracted to factories, when skills cannot be produced as quickly as they are needed, when errors of judgment are made in planning production, and so on; (c) there appears a huge demand for new capital, both for directly productive investments and for public overhead capital. With a virtual inability to obtain such capital from abroad, capital has to be obtained from domestic saving — either forced saving derived from an inflation, involuntary saving derived from suppressed inflation and the consequent lack of sufficient opportunities to buy goods, or voluntary saving in the formal sense, whether genuinely volitional or accumulated under official pressure.

All these phenomena produce strains on the banking system of the country, strains which take many forms. There are rising cost structures, physical shortages, and government pressure to create new money. These throw the system into uneasy changes of pace, create novel situations, and necessitate improvisation, make-up, and patch-up. To keep up constantly with the turbulent dynamics of an expanding economy, to control it and direct it in accordance with the goals imposed by the government, constant vigilance is required from Communist bank managers. It may be added that the flexibility required from the banking system is not necessarily stimulated by the prevalence of state domination in the economic sphere.

On the other hand, the inflationary forces are considerably restrained by the strength of the government in Communist countries. In contrast to countries with notoriously weak and ephemeral successive governments (e.g., France or Italy), Communist governments can lay down and regulate most of the conditions of the economic life of the country within a fairly wide range: budget revenues, as well as expenditures, the volume of production (limited by technical considerations) and production costs, the total amount of monetary resources in the country and their use. The power to determine these factors is, of course, not unlimited, and depends, among other things, on the moderation of planners and on the degree of cohesion of the society, exemplified for instance in an elimination of "black market" activities. Even granting undue ambitions on the part of planners and imperfect cohesion of the society the Communist system shows substantial superiority over such economically and politically weak systems as France and Italy both in material production and its increase and in ability to avoid inflation.

In a centrally planned economy monetary *planning* rather than monetary *management* is practiced. Monetary management, or monetary policy, serves to influence the economic system in a general, nondiscriminatory way through changes in money supply and in credit terms. Only in a few instances (in this country Regulation W or X) does monetary management operate selectively, influencing a particular field of economic activity, e.g., installment credit. Even then, however, it institutes general ruling conditions within which transactions may take place, and does

not discriminate against, or favor, a *particular* transaction. One of the tacit assumptions behind the use of monetary management is that through this overall, nondiscriminating action it eliminates the least desirable, least remunerative, and therefore least necessary economic ventures. It also implies that individual freedom in determining economic actions is more important than other considerations.

Monetary planning, on the other hand, *determines* the course of economic events in that every single transaction or purpose is allotted certain pecuniary means which enable it to be fulfilled. The function of the money market, directed by the profit motive, is performed in a planned economy by the Central Planning Office, directed by a desire for certain very definite achievements. If, under the directives of the Central Planning Office, no funds are allotted for a given venture, such a venture cannot take place. The amount of money credited to a particular use also determines the size of the transaction to be performed, and so the degree of development in the given line of economic activity. In this way monetary planning controls the rate of growth and the activity of every unit and every branch of the economy. The effectiveness of that control need not, however, be, and, as we shall show, is not complete.

It should be noted that monetary planning does not, by itself, regulate the economic life of the country. The financial plan, drawn up by the banking system, merely translates the overall economic plan of the government into money terms, and thus cannot be regarded as the original determinant of the economic system.

This brief sketch of conditions in which Communist banking operates can be summed up as depicting a centrally planned, rigidly regulated, and strictly controlled system, in which the banking system serves primarily the needs and purposes of the state. The main role which remains for the banks to play is, as will be indicated more extensively later, the control over the adherence to the plan by other economic units.

The Functions of Communist Banks

The present section considers the blueprint for the operation of Communist banks. The subsequent section will provide a discussion of deviations from this blueprint.

The discussion of the functions of Communist banks may be divided as follows: creation of money, the clearing system, short-term credit, long-term credit, collection of private savings, and foreign exchange operations.

Creation of money

The central bank possesses here a virtual monopoly. It plans its future money creation in a special plan, called the Cash Plan, which is a residual of the Credit Plan: if the receipts of the central bank are not sufficient to cover the planned credits, then the bank knows that it has to issue new money in order to fulfill its credit plan. Ultimately, the amount of new money creation depends on the directives of the general economic plan of the country, drawn up by its political bosses.

The clearing system

Every enterprise is obliged to open an account with the central bank, through which the enterprise's flow of payments is directed. Bank settlements take place for amounts over a certain stated minimum. In Soviet Russia that minimum, with few exceptions, is 1,000 rubles; transfers in amounts up to 100 rubles are made in cash, and between 100 and 1,000 rubles by book cross-entries through the Liaison Ministry.

In this way all settlements for more than 100 rubles are cleared in Soviet Russia without use of money. All are finally entered in the books of the central bank. In making these cross-entries the central bank gives its seal of approval. If it does not regard a particular transaction as consistent with the plan, it may disallow the payment by a simple refusal to enter it in its books.

Since all major payments are cleared through the central bank, this bank can exercise almost daily control over the greatest part of the activity of every enterprise. It thus becomes a large accounting machine for practically all activities undertaken in the economy.

The clearing system evolved in the USSR, and being adopted in other Communist countries, has the following main distinguishing features:

(a) The enterprises which have monetary resources on deposit with the central bank can dispose of them according to their judgment, but their transactions have to be made under the control of the central bank, which guards the fulfillment of laid-down rules and the order of priority of settlements, not allowing any illegal immobilization of resources through unplanned actions.

(b) Debiting of a clearing account takes place only with the approval of its holder, with the exception of instances laid down by the law. This feature was introduced into the Soviet practice in order to protect the buyer from being supplied with goods of inferior quality without any opportunity to protest against such action. Since the time allowed for approval is limited, most transactions are in practice tacitly approved by the customers who do not submit any protests to the bank.

(c) Payments are made on the books of the bank only within the limits of resources of the payer, or within the limits of resources placed at the disposal of the banks for their execution.

(d) Payments for goods and services are made at once and use of commercial credit (granted by the seller to the buyer) is prohibited. Thus a purchasing enterprise, instead of being able to incur a debt on its buyer's account with the supplying firm, has to go to the central bank for a short-term loan to finance the purchase. This allows the central bank to obtain without any delay information about transactions made in the economy.

Short-term credit

This type of credit is, again, with minor and quantitatively unimportant exceptions, the domain of the central bank. Its aim is the financing of the flow of goods which pass through the enterprises in the productive process. This fact causes short-term credit to be given to cover only temporary needs,

under the obligation to repay the loan at a stated date.

Short-term credit follows the productive process: starting with the raw material state it finances production through its various stages to end finally in the last distribution channel. As an enterprise receives goods, it contracts a loan to pay for them. When it sells them to the manufacturer at the next productive stage, or to the distributor, it is credited with the value of the commodity thus sold, and can repay the loan. But the receiving enterprise finds itself, in turn, in need of credit — and the process of credit giving continues.

Part of the working capital of an enterprise has to be financed from internal resources of the firm. But the part which is supplied by bank credit is sufficient to establish a firm element of control over the productive activities of the enterprise. If the enterprise falls behind in the fulfillment of its plan, its revenues from the sale of its products are consequently smaller than provided for, and its need for credit accommodation greater. The central bank can in this way detect the laggards in the plan. A firm which fails to reach its planned production goals cannot obtain credit as easily as one which fulfills its planned tasks. Thus a financial incentive is added to boost the performance of Communist enterprises.

Planning its credit operations, the Communist central bank ascertains the correctness of claims for a given amount of working capital; controls the conformity between credits for particular purposes and the real needs for them, as determined by the planned tasks; and watches for the "correct" redistribution of state resources according to the actual needs of enterprises, and according to the requirements of effective and proportional development of the whole economy. These requirements represent a certain optimum of economic development, and are heavily imbued with political value judgments. In order to perform these tasks, the bank has to exercise a constant, almost daily, and systematic control over all enterprises financially subordinate to it.

A differentiation of short-term credits which is most frequently used in Communist countries divides them into those servicing the working capital needs of enterprises and those servicing the turnover of goods. The latter seems to concern the cost of raw materials bought to be used in production, whereas the former pertains to all other overhead costs incurred during the productive process. In the field of working capital, 60 percent of needs is financed from the internal resources of the enterprises, the remaining 40 percent being financed by bank loans. In seasonal fields bank loans finance a larger part of the working capital, e.g., in the food industry they finance 60 percent, and in state purchasing organizations as much as 80 percent of the value of working capital. In heavy industry, on the other hand, where seasonal fluctuations are not pronounced, the figure was about 20 percent before 1941.

The use of bank credit involves an operational charge, which is collected in the form of interest payments. Between 2 and 4 percent is charged for short-term loans, while medium and long-term loans to kolkhozes, cooperatives, and for individual house-building

carry an interest charge of 1 to 3 percent. Overdue loans carry a penalty rate of 6 percent. On the other hand, the bank pays an interest rate of 2 percent on its clearing accounts, and savings banks, discussed later, pay from 2 to 5 percent on savings accounts.

In order to discourage defaults by debtors and to maintain "the financial discipline" various credit sanctions are applied, ranging from reports to higher authorities to a stoppage of all new loans and to temporary sequestration of goods of the defaulting debtor.

Long-term credit

Investment activity is of crucial importance in any economy because it influences directly the kind and quantity of future products which will be obtained with the use of the capital goods created in the process of investment. Under Communism, the center of direction of investment activity is political. Political rules decide how much of the national resources will be devoted to the production of capital goods and how much will be left for the production of consumers' goods. In both kinds of production they decide what kinds of goods will be produced — how many furnaces, factories, tractors, power stations, and so on. In this way the future development of the country is determined by its present rulers.

The field work of investment activity is performed by specialized long-term investment banks which are vested with administrative and controlling tasks. In the Soviet Union there are four long-term investment banks: the Prombank, or Industrial Bank, which finances industrial, transport, communications, and road-building firms in the sphere of long-term investments; the Tsekombank, or Municipal Bank, which finances local governments and building construction; the Torgbank, or Trade Bank, which provides funds for capital investment by cooperatives and government trade organizations; and the Selkhozbank, or Agricultural Bank, which gives long-term credit to agriculture — kolkhozes, state farms, and farmers.

Similar division of specialized banks is being adopted in the satellite countries. This organization shows a banking structure built on strictly functional lines, with no competition among banking institutions and with emphasis on expertness, exclusiveness, and completeness of control.

The functions of the long-term investment banks may be summed up as follows: to finance investments on a nonrepayable basis; to provide long-term credits to kolkhozes and cooperatives; to provide short-term credits to construction enterprises financially linked with them (this constitutes the quantitatively unimportant exception to the monopoly of the central bank in the field of short-term credit); to conduct settlements between contractors and their clients (actual construction is characteristically done by contractors, and not by those who are finally to use the capital goods thus created, in order to strengthen control); to accumulate monetary resources for financing of capital investments; and to conduct cash operations in the field of communal and housing activity.

The funds used for financing invest-

ment activity are derived from government grants (the most important source); a part of amortization allowances; that part of incomes of enterprises which remains after deductions for the state budget and for the director's fund of the enterprise; resources from special funds; and funds of kolkhozes which have not been distributed among their members.

The investment planning system is consciously rational. Elaborate timing charts of completion of investments are prepared and the effect of each investment on production is carefully weighed. The long-term investment banks place their expert, specialized knowledge at the disposal of the central planners and pass their judgment on estimates produced by individual enterprises, giving their recommendation to plans, or withholding it.

The specialized banks are obliged to maintain a daily control of the state of accounts of firms engaged in investment work. Above all, it is considered highly important that the banks control the settlements between their customers and the contracting organizations, concerning the fulfillment of investment projects.

Collection of private savings

The recent substantial rise in the savings of the Russian population has increased the importance of the savings banks as a means for mobilizing monetary resources. The funds saved by the population are deposited in special savings banks and invested by these banks in government bonds. The Soviet fiscal practice treats increases in savings as tantamount to budget revenues. And in fact, under a planned economic system, any net saving on the part of the population frees resources for use by the state, without creating any need for additional taxation in any form, or for a new issue of money. For that reason saving is encouraged under Communism.

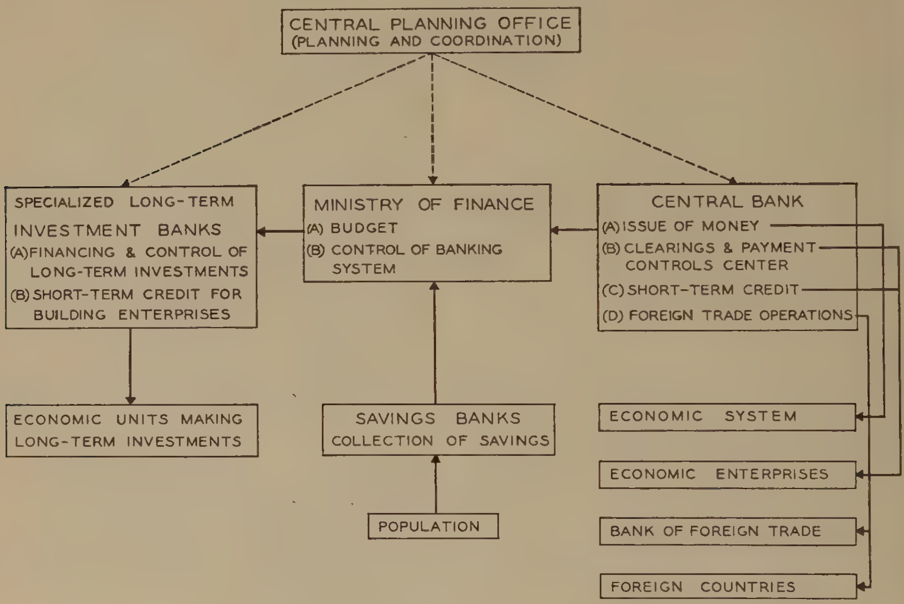
The savings bank system consists of a whole network of branches, situated in post offices, branches of the central bank, railway stations, factories, village clubs, and so on. Their activity includes in the Soviet Union, apart from the collection of savings, receipts of taxes, payment of pensions, and payment of some rewards by the state. Administration of the savings of the population is, however, the main preoccupation of the savings banks.

Foreign exchange operations

Under the Communist system, foreign trade is the monopoly of the state. The role of the banking system in foreign trade relations is, as in other spheres, strictly regulated. A special foreign exchange plan is drawn up, consisting of two parts: (a) the commercial part, in which the central bank shares the work of preparation with the Ministry for Foreign Trade, the central bank planning the monetary aspect of the trade; (b) the noncommercial part, drafted by the Finance Ministry. The execution of the foreign exchange plan is left to the central bank and, usually, a foreign trade bank, the latter working under the supervision of the former, and performing generally minor and technical operations.

The central bank has a monopoly on the purchase of gold and on dealing in

THE SOVIET BANKING SYSTEM



foreign exchange. It should be noted, however, that the majority of foreign trade transactions with the Communists take the form of barter exchanges in which there is no need for foreign exchange operations. For the remaining operations the Communist central bank maintains a network of correspondents throughout the world. These correspondents keep accounts for it, debiting or crediting them whenever a transaction is performed.

To sum up, we find, first, the central bank, with the monopoly of money creation, acting as the clearing center for monetary transactions between enterprises, possessing the almost exclusive right to grant short-term credit and having the duty to conduct foreign exchange operations. Second, there are specialized long-term investment banks, which control the field of long-term credit. Third, there is a network of savings banks occupied with the mobilization of private savings for the purposes of the state. Fourth, we may find one or two banking institutions which are of assistance to the central bank in the field of foreign exchange operations.

The system thus outlined is clearly constructed on functional lines, with the central bank playing by far the most important role. Each bank has allotted to it one or several distinctive spheres which are not encroached upon by the other banks. Competition gives way here to specialization.

The accompanying chart summarizes the functional division of communist banks and their relations to the Ministry of Finance (discussed in a later section) and to the central Planning Office. The solid lines indicate the flow of funds.

Deviations from the Blueprint

It would be erroneous to draw from the preceding discussion the conclusion that every single transaction is strictly controlled by the banking system, that transactions which do not follow the letter of the plan are promptly discovered and effectively disallowed, and that enterprises engage in simple copying of the plan without any decision making on their own.

Central planners, however able and industrious, cannot be expected to lay down minute orders concerning each transaction of the economic enterprises. On the other hand, if such a "perfection" were possible, there would be no place for industrial managers in Communist countries — only bookkeepers and accountants would be left to follow the directions. A study of the Communist systems shows clearly that industrial managers are by no means an extinct class in those systems. They must make manifold decisions on their own. Whenever such a decision is made, the banks have no measuring rod with which to compare it except their own understanding of the aims of the plan and the needs of the economy as shown in the light of that plan. Elements of estimation, judgment, and guesswork are here injected into the rigid outline of the planning system.

It goes without saying that should a manager allow himself too much latitude in his interpretation of the plan, the controlling bank can object to his expenses and possibly call his actions to the attention of the planning authorities. The sheer bulk of the work involved, however, can very well make the control rather superficial. Only when irregularities are discovered will the bank concentrate its attention on the activities of the given enterprise.

Western economic research shows that Communist enterprises spend considerable sums in a manner which could not possibly be approved by any plan. Each enterprise allocates some of its profits to the so-called Director's Fund. Nominally, this fund is to be used to increase the welfare of the workers, and expenditures from it are to be made with the approval of the workers' union. In practice, however, the manager of the enterprise spends such funds pretty much at his own will. A substantial portion of these funds seems to be spent on bribing various officials, buying goods on the gray market, or securing the services of unofficial intermediaries, who, through their connections, enable the enterprise to obtain otherwise inaccessible raw materials. Most of these expenditures are in all probability made in cash and therefore escape the control of the central bank. Those made through the banks are most certainly appropriately camouflaged.

It is contended by the Soviet writers themselves that in the field of long-term credit there exists inadequate control, that the administration of funds by the specialized banks is careless (the banks do not give enough information to their customers on financial matters and fail to guide them properly), that there is a deplorable lack of proper measures against defaulting debtors, and that the quality of the work of specialized banks, particularly in their main offices, could be improved.

The Disposition Center

The banking system under Communism is not autonomous. The Ministry of Finance has been made the disposition center for all banks in Communist countries. The Minister of Finance has the power of appointment and removal of the directors of the banking institutions, who are therefore directly responsible to him. The Finance Ministry scrutinizes thoroughly the Cash Plan prepared by the central bank, and maintains a close daily contact with that institution.

A particularly close regulation is maintained by the Ministry over the activities of the investment banks. According to the Soviet practice, the Ministry of Finance in exercising its directing function informs the long-term investment banks about the annual plans for financing capital investments. This information contains a breakdown into plans for each quarter of the year. On the basis of these plans the various ministries and departments present to the main offices of the specialized banks the financing limits (credit limits), giving the separate main items and the enterprises directly responsible for them, and showing the general sums devoted to each project. This information is passed on to the branches concerned and put by them into action.

The banking system thus becomes a control department of the Ministry of Finance, subservient to the over-all economic plan of the country and unable in any way to influence by itself the course of economic events in the system.

Books Reviewed

Basing Point Pricing and Regional Development: A Case Study of the Iron and Steel Industry. By George W. Stocking (Chapel Hill: University of North Carolina Press, 1954, pp. vii, 274. $6.50)

This is a valuable addition to the accumulating series of regional studies dealing with the factors that heretofore have retarded industrial development in the South. Dr. Stocking, Professor of Economics at Vanderbilt University and a distinguished student of monopoly problems, undertakes to analyze the effect of basing point pricing on the development of the iron and steel industry in the South, particularly in the Birmingham area. His study is sponsored jointly by the Committee of the South, established by the National Planning Association, and the Institute of Research and Training in the Social Sciences at Vanderbilt University. The empirical data are derived from heretofore unpublished statistics of iron and steel shipments during the years 1937-39, collected by the Temporary National Economic Committee and now deposited in the National Archives. More recent materials, consisting of articles, government reports, congressional hearings, commission rulings, and court decisions, are used to support the general economic and legal analysis of the basing point system. Brief attention is given to the mechanics of basing point pricing, to the economic characteristics of the iron and steel industry, and to the origin and history of restrictive practices in the industry. In a very brief concluding chapter the author suggests the elements of a sound public policy.

At the very beginning Professor Stocking recognizes that basing point pricing is merely one of several factors which have operated to retard the development of the iron and steel industry in the South. Accordingly, he supplements his investigation of basing point pricing by examination of other contributing influences, such as price leadership, uniform pricing of extras, quantity discounts, secret price-cutting, the structure of the industry as dictated by patterns of ownership, and the characteristics of supply, demand, costs, and markets. All these factors, plus the menace of general economic instability, combine to restrict competition and to perpetuate monopolistic organization and market behavior. This complex approach is valid, for monopoly is indeed a Hydra-headed monster which derives its sustenance from many sources; but it does create difficulties of evaluation. In fact, Professor Stocking has so many villains in the drama that he himself is not quite sure which is primarily responsible for the demise of competition. One infers from his conclusion that economic instability and the ownership structure are the principal culprits, with the basing point system playing only a minor role in the denouement. The effect, whether or not so intended, is to minimize the significance of basing point pricing.

In the empirical sections of the book, however, particularly Chapters 4 and

5 and Appendix C, where the basing point system is considered in isolation from other monopolistic devices and with special reference to the South, the degree of culpability is quite clear. Despite Birmingham's cost advantage, both production and freight-wise, its natural market has been continuously invaded by northern steel producers through the use of discriminatory basing point prices (i.e., by freight absorption). As a consequence, basic capacity in the Birmingham area has been restricted to a level far below the demand of the natural market; the range of product differentiation has been limited, some lines for which a large demand exists (seamless pipe and tubes for example) not being produced at all; fabricators of specialized steel products, such as rivets, plows, boilers, structures, ships, tin plate, and wire, have tended to locate elsewhere because of adverse price differentials against Birmingham. The burden of supporting this monopolistic system, with its misallocation of resources, waste, and unnecessary costs, has fallen on the people of the South in the form of excessive prices for iron and steel products. Since 1938 the general expansion of the steel industry and the government's attack on basing point pricing have brought some relief, but Professor Stocking is not confident that these gains can be extended, or even held. The decline of demand and emergence of excess capacity, the recent return to basing point pricing, and the dominant pattern of ownership and control serve to perpetuate monopoly conditions in the industry.

Unfortunately Professor Stocking is reluctant to prescribe a remedy logically consistent with his empirical analysis. This is revealed most clearly in his attitude toward f.o.b. pricing. Although he demonstrates that basing point pricing is a monopolistic device and concedes that under perfect competition all prices would be f.o.b., he rejects mandatory f.o.b. pricing as the basis of public policy. Instead, he would allow firms at their discretion to sell at delivered prices and absorb freight, provided it is done independently (i.e., without conspiracy) and does not restrict competition. This equivocal and contradictory recommendation is justified by a specious distinction between discrimination used as a *competitive* device and discrimination used as a *predatory* device (p. 192, italics supplied). His explanation as to how discrimination — a monopoly tactic — promotes competition is quite unconvincing.

Why does the author reject a pricing policy that is consistent with free competition and endorse the promonopoly, self-serving thesis of basing point advocates? The answer is provided in a most revealing paragraph: (p. 193)

> The South has a broader and more enduring reason for rejecting mandatory f.o.b. pricing, viz., the preservation of a free economy. To tell businessmen that they must price what they sell only f.o.b. plant, when in their individual judgment freight absorption might prevent bankruptcy or enhance profits, is inconsistent with the function of the entrepreneur in a competitive society. Positive interference of this sort is apt to accentuate the tendency, now everywhere around us, for the government to assume responsibility in the

guidance of individual enterprise. Eventually the government may so encroach on individual liberty in business matters that it has no alternative but to take over basic industries.

There you have it — a secret fear which "puzzles the will; and makes us rather bear those ills we have, then fly to others that we know not of." Governmental encroachment on individual liberty, "creeping socialism," is the real enemy. To avert this menace, to preserve economic freedom, we must endow private monopolists with an inalienable right to do as they please — in this instance, to sell at will all over the map and without regard to production and transportation costs, resorting to such discrimination as may appear necessary to "prevent bankruptcy or enhance profits." To perfect the illusion and render it more palatable we shall pretend that monopoly is really free enterprise and that discrimination is really competition.

Such fantasies, such upside-down semantics, conceal a fundamental paralysis of social will induced by an obsessive fear of government. So long as men fear government more than private monopoly they will deny government the power to prevent monopoly and will rationalize the latter as a lesser evil. This disposition is characteristic of the current *Zeitgeist*. It explains the prevailing mood of pessimism among antimonopolists, the upsurge of a prolific literature of rationalization, the supineness and vacillation of government on the monopoly issue. Even Professor Stocking, after many years of valiant service in the cause of free competition, is not immune to this virus. As an analytical economist he presents a powerful indictment of monopoly; then, yielding to his fear of government, he rejects the logical implication of his diagnosis and recommends a policy favorable to monopoly. One can only hope that in subsequent studies he may resolve this contradiction by a more realistic appraisal of the responsibility of government for the maintenance of free competition.

HORACE M. GRAY

Realistic Depreciation Policy. By George Terborgh (Chicago: Machinery & Allied Products Institute, 1954, pp. xxiv, 197. $6.00)

One of the most serious problems faced by the accountant in attempting to provide an estimate of the annual income of a firm is to determine the portion of fixed assets which have been consumed during the period. In the main an "accurate" measurement is considered impossible with the result that various formulae have been adopted conventionally as a solution. The formula used extensively in the United States is the straight-line depreciation, which is expressed as original cost less scrap value divided by years of life. At the present time, the use of this formula for income tax purposes is under severe criticism. This study criticizes the straight-line method and suggests other methods.

It is the stated objective of the book to reappraise existing depreciation practice in the United States from both the managerial and income tax points of view. Actually it assumes managerial

problems of depreciation are essentially the same as the tax problems and considers the latter almost exclusively. Thus it is primarily a discussion of the need for the reform of depreciation practice in determining taxable income.

The reforms suggested by the study are (1) the substitution of the declining-balance method for straight-line depreciation and (2) revaluation of assets to current dollar amounts to provide for the computation of depreciation charges which are adjusted for price level changes. If the implementation of the two recommendations simultaneously is not considered feasible, it is suggested that the first recommendation have precedence. It is then suggested that even the first recommendation could be put into effect over a brief transition period if such were necessary.

Current depreciation practice for tax purposes is held to be deficient on three counts. It is deficient because of (1) the use of straight-line depreciation, (2) the accounting methods used in computing straight-line depreciation and (3) the failure to consider the changes in the purchasing power of money. Straight-line depreciation is considered inadequate because it fails to reflect the manner in which the value of capital assets is consumed. Support for this view is provided by a theoretical study which compares the remaining capital value of an asset with the book value resulting from straight-line depreciation. These results are then supported by an empirical study of the prices of new and used automobiles and farm equipment. From these two studies the conclusion is reached that the normal value-erosion of equipment for the first third of service life is at least one-half of the total value, and for the first half of service life it is at least two-thirds of the total value. While the normal value-erosion of long-lived assets does not appear to be as rapid as for equipment, straight-line depreciation appears as a gravely retarded method of depreciation in both areas.

Because the estimated life used for depreciation is an estimate of the average life of the asset, actual retirement of assets will be dispersed around this average. Failure to recognize this dispersion by the accounting method used will distort downward even straight-line depreciation. Of the three principal methods used for computing straight-line depreciation, none allocate straight-line depreciation accurately to time periods. Primarily, this under-provision, in the early years of assets. This is so because some assets will be retired before being completely depreciated so that not all of the original cost will be charged as part of total depreciation. While the time lag in recording depreciation is due more to the use of straight-line depreciation than to the method of computing it, both tend to understate depreciation in the early years of asset life so that the total lag is compounded.

The third area in which conventional depreciation is unrealistic is the failure to adjust for changes in the purchasing power of money. Because depreciation should have as its objective the return of an equivalent amount of purchasing power, any depreciation based on original cost is inadequate

if the purchasing power of money changes.

The extent of under-depreciation is held to be considerable. If the present methods of depreciation had been consistently applied over the lives of the nation's depreciable assets existing at the end of 1953, the accumulated under-depreciation would be $30 billion and the current annual deficiency would be $2.6 billion. When the adjustment for changes in the purchasing power of money is added, the current annual understatement of depreciation amounts to $6.8 billion.

Recommendation of the declining-balance method for determining depreciation charges was made on the grounds that at a rate *double* that used for straight-line depreciation, the undepreciated value of assets over a period of time tends to conform to the actual value remaining. Further it tends to allocate depreciation accurately to time periods. Accelerated depreciation — straight-line depreciation over a period less than the life of the assets — was rejected because the resulting book values did not conform to the actual value remaining in the assets at any one time.

The adjustment for price level changes is considered from several points of view. Several index constructions were suggested as adequate, though an index of general purchasing power finally was adopted arbitrarily.

In conclusion, it was implied that in the long run the loss of immediate tax revenue might be offset by future increases in tax revenues if the recommendations were adopted.

The reviewer's over-all evaluation of this book is not especially favorable. While it might require considerable time and insight to provide information contrary to or supporting the conclusions and procedure of the study, there are so many questionable points summarily discarded or included that one begins to wonder about the accuracy of the entire study. For example, the conclusion that indirect tax gains from depreciation reform would eventually exceed the direct loss is not supportable. Also, in the early part of the book, the restriction of the empirical study on the rate at which assets decline in value to data on automobiles, trucks, and farm equipment must be questioned. On the other hand, the book proceeds quite logically from the assumptions made or prior conclusions drawn.

Norton M. Bedford

Management of the Industrial Firm in the USSR: A Study in Soviet Economic Planning. By David Granick (New York: Columbia University Press, 1954, pp. 346. $5.00)

The vast and growing literature on the Soviet Union is heavily encumbered by works which are either strongly anti-Soviet or strongly pro-Soviet. The number of volumes aiming at objectivity and approaching that difficult goal by the long road of careful, painstaking, scholarly research is surprisingly small. This volume is a welcome addition to the latter number. It is one of a series of volumes published or projected by the Russian Institute of Columbia University. It is one of the few works on Soviet firm management in the English

language and certainly the most recent.

The study is limited for the most part to Soviet heavy industry. It covers only the years 1934 to 1941. It is further limited by heavy reliance on Soviet newspapers and journals which, though useful, leave blank much of what we should like to know about decision making in the complex industrial system of the USSR. The questions posed by the author at the beginning of his volume are basic: How are Soviet managers selected, promoted, demoted? How much freedom do Soviet managers have in operating their plants? How is the management of hundreds of firms integrated for purposes of over-all planning? How well are Soviet plants managed?

The first five chapters describe the general structure of Soviet industry and the planning process. The individual firm is at the bottom of a five-tiered hierarchy. At the top is the Council of Commissars aided by the State Planning Commission. The Council's directives are put into operation by the Economic Council which in turn issues general directives to the various commissariats in charge of large segments of industry. The commissariats break down national policies into greater detail for the sub-commissariats called "glavks." And these in turn hand down detailed operational instructions to the individual firms.

In practice, any of these administrative levels may be by-passed in both directions. The director of a firm must not only deal with his immediately superior glavk organization but must deal with many different glavks and commissariats in both procurement and sales. The overlapping of authority is serious. To complicate matters, the Communist Party, whose membership constitutes about 10 percent of the total manual and technical work force in heavy industry, shares both in theory and in practice responsibility for the carrying out of national policy. The exercising of this responsibility may take the form of direct interference with a manager's decisions. It may be indirect in the form of protests within the plant through workers' councils or external opposition through the public press. Or there may be no interference with the operations of a manager, per se. The manager simply disappears.

The question immediately arises: How can the Soviet manager work efficiently if he must look in so many directions at the same time? Mr. Granick found that in practice, the manager does not. First of all, to be successful a manager must be politically right, "every day." Second, he must try desperately to meet his production quotas. If he does this he usually ignores the barrage of directives from above. Illegal buying and selling of scarce goods and doctoring of accounts is commonplace. Personal relations between managers and buyers and sellers from other firms is paramount in order to obtain supplies or sell unneeded products. Even if a manager succeeds in doing all these he can be sure only that "there is little chance that he will direct the same plant for long." (p. 57) The turnover of managers in major firms is astounding. Two or three years is all a manager may expect to stay in one plant. Managers are promoted fast, demoted fast, or disappear fast.

One cannot read Professor Granick's account without wondering how Soviet industry produces as well as it does. His opening chapters do raise one important question for speculation. May it not develop that, over time, technicians and professional managers will gradually come to dominate the Communist Party and all key administrative posts? The tendency is there, interrupted from time to time during the 1930's by Stalin's "purges" of the management class. Such a development would of course be a negation in fact, if not in theory, of Marxist ideology.

Several excellent middle chapters are devoted to Soviet criteria in measuring managerial success. The author concludes that the Soviets have not yet been able to establish a single criterion. The Council of Commissars emphasize first one and then another yardstick. In view of this uncertainty the Party must rely on strong financial incentives such as high salaries, good housing, a car and chauffeur, and prestige (however ephemeral) to induce able men to take over the direction of large firms. There appears to have been no lack of supply of hopeful candidates. Another excellent chapter discusses the role of the Communist Party in the life of the firm. On one hand a manager is supposed to have complete authority over all employees in his firm. The Party is also responsible. It is supposed to work *through him* to arouse the masses to greater production. Professor Granick found these two lines of authority in constant conflict in practice. Even Soviet theorists have had difficulty in reconciling them. Reconciliation actually occurs only when a manager personally succeeds in balancing the two. And his difficulties are those of a nervous man walking a slack rope in a high wind on a dark night without a safety net. It is no accident that there are no "older age" managers in the Soviet Union.

The weakest chapter in an otherwise excellent volume is, oddly enough, the concluding one. Instead of bringing together the conclusions of the previous 13 chapters the author begins his last chapter by describing the theoretical bureaucratic structure propounded by Max Weber. He then summarizes the views of a few of the theoretical critics of Soviet policy and attempts to contrast the actual practices in Soviet industry with these theoretical models. The result is labored and discursive. Professor Granick's own findings never get adequately summarized. The reader himself is left to note some of the significant conclusions. One of these is the number of very serious conflicts within the Soviet managerial system which have never been reconciled and which greatly reduce Soviet efficiency. Another is that the role of the firm manager in the Soviet system is constantly changing. Despite its weaknesses, we should not underrate the system. If the technicians get complete control of the Party, the industrial potential is tremendous indeed. It is to be hoped the Russian Institute will finance another study which will bring Professor Granick's analysis up to date.

JOHN B. PARRISH